How To Buy Real Estate Without A Bank Loan

WRAPAROUND MORTGAGES

HELPING GUIDE INVESTOR STUDENTS TOWARDS FINANCIAL FREEDOM.

BY: DAVID KRAUS & ARGELIA VILLARREAL

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BUY a House Without a New Loan

Buying a house with a wraparound mortgage is one of many ways to buy real estate with owner financing. Any time a seller will finance part of the purchase of a home, it's usually a good thing, especially if it means the buyer doesn't have to apply for a new bank loan. But buying real estate using a wrap is certainly a good option too.

If you have a basic understanding of owner financing in general and wraparound mortgages in particular, you can buy a house using a wrap, hopefully faster and with less hassle than applying for a new bank loan. Like the garden-variety real estate sale, buying using a wrap involves a contract, an inspection period, and a closing, but because there will be no new bank financing (and possibly no title insurance), the entire transaction could take 7 days or less. If you have a seller who has agreed to sell you his house using a wrap, here's a step-by-step guide to buying a house, land or commercial property with a wraparound mortgage.

The Wraparound Mortgage Explained

The wraparound mortgage is an excellent and perfectly legal way for investors and homeowners to sell their properties faster and for more money than by selling for cash only. It's also a great way for Realtors to get their listings sold before they expire and avoid losing their commissions.

The traditional, "garden-variety" house sale works like this: Sam Seller owns a house. He'd like to sell it for $210,000. He owes $160,000 on his first mortgage (deed of trust in Texas) to Big Bank. Sam puts his house on the market, either with a Realtor or For Sale by Owner (FSBO). Bill Buyer comes along and wants to buy Sam's house, and they agree on a purchase price of $200,000. Bill puts down some earnest money, they sign a contract, and then Bill applies for a new mortgage from Bigger Bank. Bigger Bank checks Bill's credit, asks for his tax returns, pay stubs, and a pint of blood, and makes Bill pay for a new appraisal, a new survey, loan fees, underwriting fees, etc. At closing, Bill pays Sam a down payment and Bigger Bank pays off Big Bank's mortgage, Sam's Realtor, the title company, etc., before giving Sam whatever is left over. Big Bank's mortgage is paid off completely and goes away when Big Bank files a 'release of lien' in the county records. Bill now owns the house and Bigger Bank has a first position lien on the house with the new mortgage.

The wraparound mortgage works a little differently. Remember, Sam Seller owes $160,000 on his mortgage with Big Bank. Sam enters into a contract to sell his house to Bill Buyer for $210,000. But this time, Bill does not apply for a new mortgage with Big Bank. Instead, Sam acts as Bill's bank and mortgage lender. At closing, Bill pays Sam a $21,000 down payment (10%) and gives Sam a promissory note for the balance of the purchase price ($189,000), plus a deed of trust or wraparound mortgage securing Sam's lien against the property. Sam gives Bill a deed, so Bill now owns the property, but Sam does not pay off Big Bank. Instead, Bill pays Sam every month, and then Sam pays Big Bank out of what he receives from Bill. Bill's new debt has "wrapped around" Sam's old debt – hence the name.

This arrangement – Bill pays Sam, Sam pays Big Bank – can continue indefinitely, with Sam getting monthly cash flow from the spread between his payment to Big Bank and Bill's payment to him. If Bill and Sam agree, they can include a balloon payment in Bill's note, so that Bill will need to re-finance or re-sell the house within a certain time, usually 3-5 years. When that happens, Bill will pay off his note to Sam and Sam will pay off his note to Big Bank, and the new loan will take a new first position lien on the property. But until Bill sells the property or refinances, there will be two mortgages on the property– Sam's mortgage with Big Bank and Bill's wraparound mortgage with Sam.

What are the Advantages of the Wraparound Mortgage?

Well, for Sam Seller, he gets a cash down payment at closing, monthly cash flow for as long as both mortgages are in place, and another cash payment when Bill Buyer re-finances in a few years. He also gets a better price, better terms and a quicker closing for his sale, because he doesn't have to wait for Big Bank to process the loan, do the appraisal, etc. And if he sells with 10% down, he can still pay his realtor commissions and keep everybody happy.

Bill Buyer also gets the advantage of a quick closing, and he doesn't have to go through the lengthy loan application process, credit check, etc. If Bill has some credit issues or other reasons why he wouldn't be able to qualify for a new mortgage loan right now, he can still buy a house now and have a couple of years to get his credit issues straightened out.

Now, it is true that selling a house on a wrap usually violates triggers the due-on-sale clause in the original deed of trust. That clause, which is included in almost every deed of trust, says that if the seller conveys the property without paying off the first note, then the lender can accelerate the note and call it due. It is not necessarily a violation of, or a default under, the deed of trust, and it is absolutely not "illegal" to do this type of transaction. It is simply a clause that gives the lender the right, but not the obligation, to call the note due.

It is true that this is a risk for both seller and buyer in this type of transaction. **But how great a risk?** Banks are not in the business of foreclosing on houses and owning real estate. Banks are in the business of making loans and getting paid back. As long as the payments remain current, what incentive does the bank have to accelerate the note? They have enough non-performing loans to worry about, why would they care about one that was being paid on time? As a practical matter, banks almost never "call notes due" based on the due-on-sale clause as long as they are still getting paid. In fact, I have never even heard of it happening if there were no other violations of the mortgage or other issues with the note.

It is a minuscule risk, but it is an actual risk and one that should be disclosed to everyone – the seller, the buyer, the title company, even the lender itself. And Texas law requires a notice to the lender and the buyer if a property is being sold on a wrap and no one is buying title insurance.

With more and more buyers having trouble getting financed for a traditional bank loan, seller financing in general and wraparound mortgages in particular will become more and more common.

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Contract for Deed vs. Owner Financing vs. Lease-Option in Texas

Takeaways

- Don't do Contract for Deeds. They are bad.
- Lease Options are possible but extremely difficult to do under Texas law.
- Owner Financing deals can be difficult to find, but can be a competitive advantage for sellers who offer it.

Most residential sales in Texas, and all that are done with the assistance of a Realtor, are done on the Texas Association of Realtors contracts. The below methods are rarer and irregular methods of buying real estate, and that are often confused. These three methods of buying/selling real estate share some things in common, but are wildly different in practice. It's important to know the differences!

Contract for Deed

Legitimate? No

Also known as a land contract, executory contract or installment sale, these were once very common investor tools in residential sales. That is, until 2005 when the Texas legislature came down hard on Contracts for Deeds and Lease Options in Texas. As a result, neither are frequently performed in Texas, and legitimate contract for deeds are almost unheard of (and rightly so).

A contract for deed is just a contract, usually with a larger up-front down payment (10% – 25%), with set monthly payments until all the payments are concluded and the buyer receives the deed. On the surface, it looks similar to a typical mortgage or owner financing deal. However, contract for deeds is just a contract – a piece of paper between buyer and seller. If a buyer ever wanted to enforce their rights, it would require an expensive lawsuit. If a seller wanted to take back the property, it would only take the slightest infraction on the buyer's part and as little as a three-week eviction process.

This structure made it very easy for investors to prey on "buyers", who would lose the home and their money invested if the owner could find even the slightest excuse to shred the contract. The investor would get the house back, and the opportunity to sell it to someone else. Some investors would sell the same house several times in the same year, collecting $10,000 in down payments for each sale.

Nowadays, Contract for Deeds are hazardous to both sellers and buyers in Texas. Hazardous to the seller because the Texas regulations passed in 2005 make it very painful for sellers if anything goes wrong. Hazardous for buyers for the reasons described above.

If someone is offering you a Texas residential property with contract for deed terms, run in the opposite direction.

Who Might Use It

Nobody. No one. Nada. This is essentially not a legal residential agreement in Texas and, if you are the buyer, you have zero protections.

Owner Financing

Legitimate? Yes

Also known as seller financing, is when the seller is also effectively the buyer's lender. The seller must own the property free and clear (paid off any mortgages). The seller would collect monthly mortgage payments (instead of installment payments in contract for deed, or rent in the case of lease options), and have the house as collateral in the case of default. The terms are usually more generous to the seller than traditional financing, and it might be a way to get a higher price for the property, or get a better cash flow than renting the property out.

Hey, isn't that the same as Contract for Deed described above? Monthly installment payments until the "loan" is paid off?

No. The difference is that an owner financed deal is recorded with the County. It is a legitimate deal and the buyer's interests are protected. An additional protection is that a trustee has the deed instead of the seller, so if the seller dies or flees to Mexico or conveniently forgets

that there is a contract, the Deed of Trust in an owner financed deal will show that the buyer is the rightful owner.

Also, if a buyer is late on a payment with an owner financed deal, the seller must go through the foreclosure process. In a contract-for-deed deal, they can simply evict you in a week.

Lastly, a buyer can also sell the property when owner financed, because the deed is with the trustee. If it were a contract-for-deed, then the seller has the deed and the buyer has no evidence that they even own anything to sell.

This is the only method of these three that you can (and should) use as a buyer or seller. A seller can simultaneously advertise for conventional buyers and buyers seeking owner financing. An otherwise credit-worthy buyer may have circumstances that prevent them from getting a traditional loan. An advantage of selling your home with owner financing is you will likely get more generous terms – higher price, above-market interest rates, and larger down payments – but of course you are getting paid in monthly mortgage installments and not one lump sum.

Who Might Use It
Anyone, especially buyers having a hard time getting approved for a traditional loan, but has money for a significant deposit (20% or more), or sellers having a hard time getting the price or cash flow they need for their house.

Lease Option

Legitimate? Maybe
Also known as rent-to-own, it is similar to the other two methods above in that you are making regular payments – in this case rent instead of a mortgage. A renter signs a typical lease, but also an option to buy the property at a specific price, and a length of time that the buyer/renter has that option (maybe a year). Unlike the other methods above, you do NOT have to buy the home. You can rent and choose later during the term whether or not to buy the home. Depending on the agreement, the rent you already paid might go toward the purchase price once you exercise your option.

Also, unlike the other two methods, a lease option ends with traditional financing. Generally, you will rent until you can get a traditional lender with an FHA loan, or conventional loan, or whatever, and then buy the house.

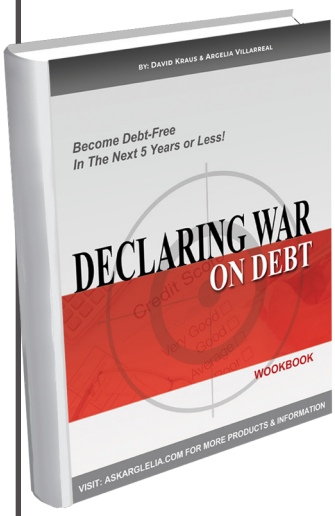
Lease options are tricky. Texas frowns on them. There has been many cases of buyer-tenants being cheated by sellers, and Texas laws are built to try to discourage lease options. But they do still exist.

You are not going to be able to find lease-options on a Texas MLS or from real estate agents. Instead you would have to approach one of the few real estate investment companies that offer lease options. It is important to find a reputable one, and you would likely do well for yourself to bring along a lawyer, too.

Who Might Use It
Buyers who can't yet get approved for a traditional loan, but are close (6-12 months away).

Find Freedom From Debt

Did you know that a debt-free life is something that Americans feel they will never enjoy? According to an article published on CNBC.com, 21% of Americans believe that they will never pay off their debts.



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Seller Financing Using a Wraparound Mortgage

How it Works

A Seller provides a Buyer a non-qualifying wrap financing for a maximum 5 year (balloon) period, without payoff of the Seller's existing mortgage.

The Buyer provides a cash down payment to negotiated Seller wrap financing. Within the max 5-year balloon period, the Buyer pays off wrap financing (including Seller existing mortgage) by refinancing or sale of home.

The Seller realizes deferred equity (if any) at payoff. The Buyer has utilized wrap as interim financing to own property and sell or refinance into mortgage loan.

Who would be a Wrap Seller?

A motivated Wrap Seller includes:

- Purchaser of a new home
- Investor
- Sophisticated Sellers
- Retirees
- Those on a deadline to purchase a new home
- One who is relocating (or already relocated)
- Those who want to close fast!

Who would be a Wrap Buyer?

A motivated Wrap Buyer includes:

- Bankrupt
- Graduating college student
- Sophisticated Investors
- New Business Owner
- Divorced
- Anyone with bad credit
- Those who want to close fast!

Sample Transaction

PURCHASE

1	Purchase Price	$100,000
2	Principal Balance of Existing Mortgage (Seller Prior Note)	$ 80,000
3	Sellers Equity	$ 20,000

WRAP FINANCING

4	Cash Down Payment (1/2 Seller Equity) #3	$ 10,000
5	Financing Provided by Seller (Wrap Note)	$ 90,000

PAYOFF

6	Seller Payoff	$ 90,000
7	1st Lien Principle Balance (Original Note) #2	$ 80,000
8	Cash to Seller on Payoff of (1/2 Seller Total Equity) #3	$ 10,000

Closing costs are negotiable but normally shared by Seller & Buyer.

Wraparound To Do List

BE A MOTIVATED Buyer and/or Seller
Seller Motivations – URGENCY: Out of area move, divorce, job loss, behind in payments, medical expenses, impending new home closing, etc.

Buyer Motivations – HAVE CASH: 2 years from bankruptcy, credit issues, new business owner, etc. Provide deal points to our office.

Parties attend "no risk" Pre-Closing Conference (PCC) with our team for a detailed explanation of the wrap financing dynamic, issues and procedures. On party's approval, closing is scheduled for 7 days or later.

If either Buyer or Seller chooses to terminate after PCC explanation, the contract is terminated at no cost to either party.

Parties pay closing costs that are **MUCH LOWER THAN NEW LOAN CLOSING!!!** Let us take you through the process.

The following documents need to be signed and/or delivered before the closing:

Agreement for Purchase and Sale of Real Estate – Buyer-Friendly
This document does not convey ownership of real estate, it is simply a promise for you to buy and for the seller to sell the property under certain conditions. This agreement allows you 30 days or an agreed amount of time to inspect the property and the relevant documents and terminate for any reason or no reason at all within that option period. It also contains an agreement for the seller to convey all the personal property on the premises to you and a number of other pro-buyer provisions.

If you are concerned that the seller may try to sell the property to someone else if a better deal comes along, you may want to record the agreement (or a memorandum of the agreement) with the county clerk, which would create a "cloud" on the title and allow you to enforce your agreement in several different ways.

Notice of Conveyance Encumbered by Lien
This document is of no real concern to you as the buyer. If either you or the seller is buying title insurance, this disclosure is not required, and even if there will be no new title policy, the obligations and potential liabilities for non-disclosure fall on the seller, not you. If you're interested in this sort of thing, you can take a look at the Texas statute that requires the disclosure and establishes the penalties for the seller who fails to comply.

Authorization to Release Loan Information
You will definitely want this document when you sign the contract so that you can confirm all the information about the first mortgage (the seller's mortgage that is not being paid off). Usually, requesting a copy of the latest statement will tell you the current principal balance, interest rate, monthly payment, and any amount in arrears, and sometimes will include information about the tax and insurance escrows, if any.

Limited Power of Attorney for Real Estate
It is okay to ask for this document at contract signing, but it's certainly fine to wait until closing to get the seller's signature. When the seller executes the POA and names you as the seller's attorney-in-fact, it gives you the legal right to "stand in the shoes" of the seller in any situation relating to the property. You can do anything with the property that the seller could do – sell it, lease it, service the first mortgage, communicate directly with the first mortgage lender, etc. It is not absolutely necessary that you have a POA for this transaction, and some sellers may object pretty strongly, but you are taking full responsibility for the property and you should want full control over the property. If you don't comply with the terms of your agreement, however, the seller would be able to revoke the POA and foreclose if necessary.

The following documents need to be signed at closing:

(General) Warranty Deed
This is the document that conveys title to the property. Even though the first mortgage is not being paid off, you are buying the property and taking legal title. The general warranty in this deed is the most expansive warranty of title allowed by law; the seller is warranting to you, the buyer, that no party has any superior claim of title to the property, including claims that may have arisen before the seller bought the property himself. The seller may reasonably request a vendor's lien be included in the deed, but may not, because the seller will have a lien against the property when the deed of trust is recorded (see below). This document needs to be signed and notarized because it will be recorded in the county's property records. You should record the original deed and have the recorded original mailed or delivered to you, with a copy to the seller.

Note Secured by Wraparound Mortgage
You are the borrower or maker and the seller is the lender or payee. This document is not recorded.

Deed of Trust (Wraparound Mortgage)
This is the actual document that secures your promise to pay the note by creating a lien against the property you are buying. If you do not pay the note as promised or otherwise default, the seller could accelerate the note, although this form does not include a power of sale that would allow the seller to foreclose easily. The seller may ask for a deed of trust and want to include a power of sale, which is standard. The seller may also ask for language in the deed of trust to secure your assumption of the obligations in the first mortgage (even though you are not formally assuming that mortgage, just agreeing to make the payments on it). This document needs to be signed and notarized because it will be recorded in the county's property records. The seller should record the original and have the recorded original mailed or delivered to the seller, with a copy to you.

Closing Agreement and Due-On-Sale Acknowledgment
This is a crucial document that must be signed and initialed by both the seller and the buyer. It is an acknowledgment by both parties that the underlying mortgage (the first one, held by the original lender) is not being paid off at closing. This means that the mortgage is still in the seller's name and must still be paid every month. It also means, most likely, that the conveyance of the property will trigger the "due-on-sale" clause, which would allow the original lender to accelerate its note or "call the note due." If either of those things happens (the first mortgage does not get paid or the first lender accelerates the note), then the lender could foreclose on the property, which would wreck the seller's credit and wipe out the seller's wraparound mortgage and the buyer's ownership of the property. So everyone needs to understand this and sign and initial this document. This document will not be recorded, but the seller needs to keep a signed original of this document and keep it in a very safe place (preferably a scanned digital copy and an actual signed original).

Limited Power of Attorney for Real Estate
If the seller has not already executed this document, the buyer should request it at closing. (See page 8)

Bill of Sale and Assignment
The buyer's purchase agreement should specify the personal property that will be conveyed along with the real estate, and if there are any leases, deposits, escrow accounts, vendor contracts, or other agreements associated with the property, the buyer should get an assignment of all of them at closing.

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Frequently Asked Questions

What is a wraparound transaction?

A wraparound transaction is a form of creative seller-financing that leaves the original loan and lien in place when a property is sold. The buyer usually makes a down payment, gets a warranty deed (title), and signs a new note to the seller (the "wraparound note") for the balance of the sales price. This wrap note, secured by a new deed of trust (the "wraparound deed of trust"), becomes a junior lien on the property behind the existing first lien. The buyer makes monthly payments to the seller on the wrap note and the seller in turn makes payments to the first-lien lender. The original lender's note is referred to as the "wrapped note" and it remains secured by the existing "wrapped deed of trust." It is possible to wrap more than one prior note (e.g., an "80/20").

Often the principal of the wrap note to the seller exceeds the amount of the payoff on the wrapped note. This is the seller's profit. Alternatively, the buyer may make a cash payment to the seller for the seller's equity, and the wrap note payment will then be structured to correspond closely to the amount of the payment on the wrapped note (referred to as a "mirror wrap").

Specific wrap terms can vary, but the wraparound principle remains the same. Wraps may be done on both residential and commercial properties. Wrap paperwork begins with the earnest money contract which should include an addendum setting forth the terms of the wrap. At closing, details of the wrap should be contained in a comprehensive wraparound agreement.

Alternatively, if the parties are clear on terms and ready to move forward immediately, they can skip the contract phase and request that the attorney prepare wrap documents for immediate closing.

If and when the buyer gets a refinance loan, the wrapped loan is paid and released, and the seller keeps any cash that exceeds the payoff amount of this first lien. The main difference between a wrap and a conventional sale is that the seller must wait until the wraparound note matures or is paid in order to receive the full sales proceeds. Wraparound financing is sometimes referred to as subordinate lien financing.

Wraparound Documentation should include:

(1) a wrap note signed by the buyer;
(2) a wrap deed of trust securing payment of the wrap note;
(3) a warranty deed with vendor's lien conveying title to the buyer; and
(4) a wraparound agreement covering miscellaneous details.

A short-term note for part of the down payment may also be included.

The interest rate on the wrap note is often higher than that on the wrapped note since seller financing usually carries a rate slightly higher than market. The wrap note is often amortized over 15 or 30 years. In the past, most wrap notes were ballooned in 3 to 7 years, giving the investor a reasonably short time horizon for realizing a profit; however, Dodd-Frank now requires that the seller affirmatively determine that the buyer has the ability to repay before a balloon may be used.

Other Forms of Seller Financing

Wraps are a form of seller financing. There is no disputing it. Dodd-Frank and the SAFE Act apply.
Residential lease-options exceeding six months and contracts for deed were both restricted by changes to the Texas Property Code made in 2005. Because the Code now imposes severe penalties on sellers if strict, burdensome rules are not followed, investors have moved away from lease-options and contracts for deed.

Only a few types of residential owner financing remain practicable:

Traditional owner finance, used when residential property is paid for; wraparounds; and land trusts, which involve temporarily deeding the property into a trust until a credit-impaired buyer can obtain financing.

How is a wrap different from a contract for deed?

A wraparound is an "executed" (complete) transaction as opposed to an "executory" (incomplete or unfinished) transaction. The buyer gets a deed to the property at closing, not at some future time. Therefore, the executory contract rules contained in Prop. Code Sec. 5.061 et seq. do not apply. In the event of default by the buyer, the seller must foreclose in order to get the property back. This is usually not an undue hardship since Texas has one of the fastest non-judicial foreclosure statutes in the country.

What about doing a wrap but delaying delivery of the deed to the buyer?

Some wraparound arrangements provide that the deed to the buyer will be held "in escrow" (often by a lawyer) as "security" for a period of time – for example until the buyer pays in the full down payment. The wrap paperwork then states that the buyer is only leasing until the deed is delivered out of escrow. This is generally a bad idea. A material item of the transaction – the most material item, in fact, the warranty deed – is un-delivered. Since the deal is unfinished, it qualifies as an executory contract and is subject to the requirements and penalties of Prop. Code Sec. 5.061 et seq. Note that this statute has a nasty tie-in provision that makes violations of Sec. 5.061 also violations of the Deceptive Trade Practices – Consumer Protection Act (DTPA).

The practice outlined in the preceding paragraph is different from the "security deed" technique. A security deed is a deed back from the buyer to the seller that is intended to be filed by the seller only if the buyer defaults – i.e., in lieu of going through foreclosure. This can legally be done but it is risky since it is possible that a future court may disapprove of this avoidance of foreclosure procedures.

Remember, real estate investors are not the most beloved of persons in a courtroom. The common perception is that investors are greedy predators exploiting the unfortunate. Juries are often happy to award treble damages and attorney's fees against investors, so caution is in order.

Isn't a wrap the same thing as an assumption?

No. In an assumption, the buyer formally assumes the legal responsibility for paying the existing first-lien note. Sometimes this is done with the approval of the seller's lender, paying an assumption fee, and signing onto the debt; sometimes the promise to assume the existing debt is made directly (and only) to the seller by means of an assumption deed. Either way, it is expressly stated that the buyer is taking on the legal obligation of paying the first-lien note. This is not the case in a wrap, which is a kind of "subject to" transaction. The first-lien note remains the exclusive responsibility of the seller.

In a wrap, therefore, the first-lien note and the deed of trust securing it remain undisturbed. A new note (the wrap note) secured by a new wrap deed of trust is created. In other words, there are two separate and independent sets of payment obligations: the seller remains obligated on the wrapped first-lien note until it is paid and released; and the buyer becomes obligated to the seller on a new wrap note and wrap deed of trust. These obligations coexist.

How can I be sure a wrap is legitimate?

Wrap transactions are legitimate, primarily because there is nothing that says they are not. There are numerous Texas cases in which wraparound transactions have been upheld. Even the State Bar of Texas, in its Real Estate Forms Manual, publishes suggested forms for wrap documents, although they are elementary in nature.

People occasionally worry that a wrap transaction may cause the first-lien lender to accelerate the wrapped note pursuant to the due-on-sale clause contained in the wrapped deed of trust. It is possible but unlikely.

Are there recent laws affecting wraparounds?

Yes. Recent laws include the Texas Secure and Fair Enforcement for Mortgage Licensing Act of 2009 (the SAFE Act or "T-SAFE as implemented in Texas) and the federal Mortgage Reform and Anti-Predatory Lending Act (the Dodd-Frank law). Even though the SAFE Act and Dodd-Frank impose limits and conditions on owner finance, such transactions (including wraps) continue to be legal.

The SAFE Act

The SAFE Act imposes a licensing requirement (a residential mortgage loan origination license or "RMLO") on certain types of owner financing extended

by persons who are regularly engaged in selling owner-financed residences. A seller is required to be licensed if the property is not the seller's homestead and/or if the sale is not to a family member. So, if the property is a rental house being sold to a non-family member, then the seller is required to have an RMLO license from the Texas Department of Savings and Mortgage Lending (TDSML). Obtaining the license requires training, a background check, and an exam. Note that the licensing rule applies only to residential wraps.

There is relief for sellers who are not in the business of regularly selling owner-financed residential properties. The Commissioner of the TDSML has ruled that the SAFE Act will not be applied to persons who make five or fewer owner-financed loans in a year, thus preserving the so-called "de minimis exemption" of Finance Code Sec. 156.202(a)(3).

The Mortgage Reform and Anti-Predatory Lending Act (aka the Dodd-Frank Law)

Title XIV of the Dodd-Frank law pertains to residential loans and lending practices. Dodd-Frank overlaps the SAFE Act in its regulatory effect and legislative intent. It requires that a seller/lender in a residential owner-financed transaction determine at the time credit is extended that the buyer/borrower has the ability to repay the loan (the ATR rule). The seller is generally obligated to investigate the buyer's credit history, current and expected income, current obligations, debt-to-income ratio, employment status, and the like in order to make this determination. This law provides for a de minimis exception for persons doing not more than three owner-financed transactions per year (so long as the seller/lender is not in the building business) – but the loan must be fully amortizing (no balloon) unless the sale is a one-time event within twelve months by a private, non-builder seller (which excludes most investors); the seller must determine that the buyer has the ability to repay the loan (and this must be supported by verifications and documentation), but with the same exception as with balloon notes; and the note must have a fixed rate or, if adjustable, may adjust only after five or more years and be subject to reasonable annual and lifetime limitations on interest rate increases. See CFPB reg. sec. 1026.36(a)(4).

Dodd-Frank also provides that the note must have a fixed rate or, if adjustable, may adjust only after five or more years and be subject to reasonable annual and lifetime limitations on interest rate increases.

Dodd-Frank is a hugely complex law and is still undergoing interpretation and rule-making by the Consumer Finance Protection Board. Their rules are a challenge to understand, even for the most intelligent investor or attorney.

The intent of Dodd-Frank is essentially to put an end to the practice of making of loans to people who cannot afford to pay them back. Read our article on The Dodd-Frank Law in Texas for more details.

What if there is more than one existing lien?

It is not uncommon to wrap more than one note and lien (e.g., a first and second lien). The prior liens may even be to different lenders. The principle is the same: the buyer pays the seller on the wraparound note, and the seller then pays both prior notes. The lien securing the wraparound note is subordinate to both of the prior liens.

Can you give an example of a wrap?

Consider the example of 123 Oak Street which is valued at $100,000 but has been slow to move. There is a first lien in the amount of $50,000 to Apple Bank and a second lien in the amount of $25,000 to Orange Bank which, taken together, result in $25,000 equity. In the usual case, a purchaser should be able to make a down payment and obtain third-party institutional financing so that the seller receives $25,000 at closing and goes merrily on his way. But what if the buyer is unable to get traditional financing? The solution is a seller-financed wrap note that may be in a premium amount – say $110,000 – which is subordinate to the notes due Apple and Orange Banks. The wrap note will likely bear a higher than market rate of interest. It will be secured by a wrap deed of trust that enables the seller to conduct a traditional foreclosure if the buyer defaults on the wrap note.

Is this a device to get sub-prime buyers into homes?

Perhaps, but prudent investors will require the buyer/borrower to have a substantial down payment. The seller/lender should evaluate and approve the buyer's qualifications just as any other lender would. In fact, Dodd-Frank generally requires this. The wrap should

be viewed as a legitimate device to sell property to reasonably qualified buyers who have money to put down and can afford the monthly payments. For less qualified buyers, a land trust may be the better option. See Land Trusts Training.

Can wraps be used in conjunction with land trusts?

Yes. There may be circumstances where it may be a good idea to first transfer the property into a land trust and then do a wrap, but this requires more complex documentation since a trust agreement will also have to be prepared.

Are wraps just for homes?

No. Both residential and commercial wraps are possible. Commercial liens are more likely, however, to contain provisions that expressly prohibit any transfer of title without prior lender consent. In all cases, but especially in commercial cases, one should carefully review the deed of trust securing existing loans before proceeding with a wrap.

Why would a seller do a wrap?

The wrap seller can unload property at full market price (or even higher) – property which might otherwise have to be discounted or sit idly on the market. The seller gets at least some cash today (the buyer's down payment) which either goes into the seller's pocket or is used to reduce principal on the wrapped note (or a combination of both – this is negotiable). The seller is then out from under the payment burden, although the seller must continue to remain involved by forwarding payments to the first lienholder. The seller also gets the benefit of any spread between the interest rate on the wrapped note and wraparound note.

Why would a buyer do a wrap?

That is an easy question. The buyer does not have to apply and qualify for a new loan, at least not immediately. The buyer gets title to the property and immediate possession without lengthy delays, expensive loan fees, and closing costs.

Why would a broker encourage a wrap transaction?

Aside from meeting objectives of the broker's client, the buyer's down payment supplies cash for the broker's commission to be fully paid at closing, just as with any other transaction.

Is title insurance available?

Yes, but availability is limited. Some title companies are more inclined to insure wraps than others. Certain underwriters are not comfortable with the wraparound process, for reasons of their own. It may be necessary to "shop" title companies until a wrap-friendly title company is found.

If a title company is issuing insurance, then closing will be held at the title company. However, most wraps are closed without title insurance in a lawyer's office based on an informal title search or a title report. After all, while title insurance is customary in Texas, it is not required. A title report may suffice for an investor.

Isn't a wrap a breach of contract with the lender? What about the due-on-sale clause?

A wrap transaction is neither a breach of contract nor a violation of due-on-sale. The due-on-sale clause merely gives the lender an option to take action if it chooses. Look closely at paragraph 18 of the FNMA deed of trust: it says that a lender may (not must) accelerate. This is not prohibitory language. (See Attachment Pg. 17)

Isn't there some kind of notice requirement before doing a wrap transaction?

Yes. Prop. Code Sec. 5.016 requires that the seller (1) give seven day's notice to the buyer before closing that an existing loan that will remain in place; (2) inform the buyer that buyer has this same seven days in which to rescind the earnest money contract without penalty; and also (3) provide a seven-day notice to the lender. These notices are all the obligation of the seller and must be in the form prescribed by the statute. Actual lender consent, however, is not required, which makes this a rather odd law. Lender notices, most often sent to the loan servicer, generally produce no response.

Note that the buyer's opportunity to cancel is an exclusively pre-closing remedy. There is no right of rescission after closing has occurred.

Prop. Code Sec. 5.016(c)10 provides an exception to the notice requirement when "the purchaser obtains a

title insurance policy insuring the transfer of title to the real property." Thus if you are able to get a title company to insure your wrap, you can dispense with the seven-day notices.

This is a law that has no teeth to speak of. As a consequence, it is widely disregarded. For now, it has not had a significant restraining effect on owner-financed transactions.

What kind of down payment should the seller get on a wrap?

Down payments are an underwriting issue. In the case of a wrap, the seller is also the lender and (like any lender) should carefully consider the risks inherent in the transaction as well as the creditworthiness of the borrower before determining the amount of the down payment and what interest rate to charge. Dodd-Frank requires such due diligence in most cases. It is likely that a down payment less than 10% likely falls within the risky category.

Can part of the down payment be financed?

Yes. There is no prohibition against it. Typically, the buyer would pay part of the down payment at closing and then promise to pay the balance within a short period – say 90 to 180 days – utilizing a second wrap note. Again, this is an underwriting issue for the seller but it is a common enough practice.

What if both notes are due on the first of the month?

The timing of payments is an issue and should be addressed in the wraparound agreement. It is a good idea to schedule payments on the wrap note seven to ten days before payments are due on the wrapped note, so as to allow time for the seller to collect payments from the buyer and then forward them on to the wrapped lender in a timely manner.

What about casualty insurance on the property?

This is a problematic area. Sellers in wrap transactions want to cancel their casualty insurance policy. This is inadvisable. The wrapped lender, which usually collects an escrow for taxes and insurance or at the very least is named as an additional insured, will be notified of the cancellation. The seller will then get a default letter from the wrapped lender who will "force place" another policy (usually more expensive) at the seller's expense. The existing policy should therefore be left in place and the buyer should obtain his own policy. This is an inherent imperfection in the wrap process. There is also an issue relating to insurable interest.

What happens if there is a loss?

Collecting on the seller's insurance policy can be problematic after a wrap since title to the property has changed hands. Even if the seller agrees to make a claim on behalf of the buyer, the insurer may refuse to pay it, asserting that the seller no longer owns it. Worse, this could potentially be construed as insurance fraud. Therefore, the buyer should procure his own casualty and contents insurance and claims should be made pursuant to the buyer's policy. It is unfortunate that this results in two policies, but there may be no reliable way around it. Insurance issues should be thoroughly addressed in the wraparound agreement.

If there is no escrow being collected by the wrapped lender, then it is in the seller's best interest to collect one from the buyer.

What about "double wraps?"

So long as the wrap deed of trust permits it, a wrapped loan can be wrapped and wrapped again – although the documentation can become prolific. This permits an investor to purchase property on a wrap and then sell it the same way (at a higher price and interest rate, of course), collecting a down payment (the investor's front-end profit) from the new buyer in the process. Usually, this new buyer commits to go through credit repair with the goal (not the requirement) of paying off the wrap note early. The investor then gets his back-end profit.

An additional, advanced trick: some investor/buyers include a "substitution of collateral" clause in their wrap notes that allows the property to be freed from the wrap lien so long as property of reasonably equivalent value is substituted in its place. If the buyer is an investor with multiple properties this could be a useful option.

What if the buyer defaults on the wrap note?

Let's review: the seller receives a wrap deed of trust that enables the seller to foreclose if the buyer defaults in

paying the wrap note. The seller can also seek and obtain a deficiency judgment if the sales price at foreclosure is insufficient to discharge the wrap note plus accrued interest and fees. Accordingly, the seller has the same ability to enforce the wrap note and lien as does any other lender.

Texas is fortunate to have an expedited non-judicial foreclosure process. Prop. Code Sec. 51.002 requires that a homeowner be given at least a 20-day notice of default and intent to accelerate the note if the default is not timely cured. If the deed of trust is on a FNMA form (unusual for a wrap) then a 30-day notice and opportunity to cure is required.

The default notice must be followed by a second letter stating that since the default was not cured, the note is accelerated and the property is being posted for foreclosure. This second notice must be given at least 21 days before the first Tuesday of the month in which the foreclosure will be held. So, a Texas foreclosure takes a minimum of 41 days – 51 days if a FNMA deed of trust is involved – although one should avoid cutting it that close when it comes to the notices. It is prudent to allow a cushion.

What if the seller defaults by not paying the wrapped lender?

The wrap agreement provides that if the seller fails to make payments to the wrapped lender the buyer may do so and receive credit against the wrapped note. The buyer should have the power to occasionally request documentary proof from the seller that the wrapped note is current.

Two related situations are of interest: What happens if the seller (1) files bankruptcy and seeks the discharge of the wrapped debt; or (2) dies leaving the wrapped debt unpaid? In either case, the buyer could be forced to refinance the debt on short notice, which may be challenging. In the case of seller bankruptcy, the seller should agree in the wrap agreement to execute a reaffirmation agreement on the wrapped debt (i.e., rather than surrendering the property to the lender seeking or otherwise seeking to avoid the debt). As for the premature death of the seller, the buyer should check to see if the seller has or can add term life protection (payoff insurance). If not, the buyer should consider protecting himself by obtaining a term life insurance policy on the seller in the amount of the balance on the wrapped debt.

What about the interest deduction?

The seller continues to be able to deduct interest paid on the wrapped loan. Nothing has changed there. As to interest on the wrap note, interest received by the seller must be reported as income, and interest paid by the buyer is deductible.

What are the disadvantages of a wrap?

Obviously, the seller has to wait until the wrap note matures in order to receive the full proceeds of the sale. Also, the wrapped loan is frozen in place and cannot be refinanced for the duration of the wrap. The seller has to collect and remit payments, which requires ongoing involvement. If the wrap borrower defaults, the seller must foreclose. In the unlikely event a loan is accelerated, the buyer may have to secure traditional financing, so the wraparound agreement should specify the amount of time in which this must be done. The parties may also be carrying duplicate casualty insurance policies. Wraps are useful devices, but they are not perfect.

Going Forward with a Wrap Mortgage

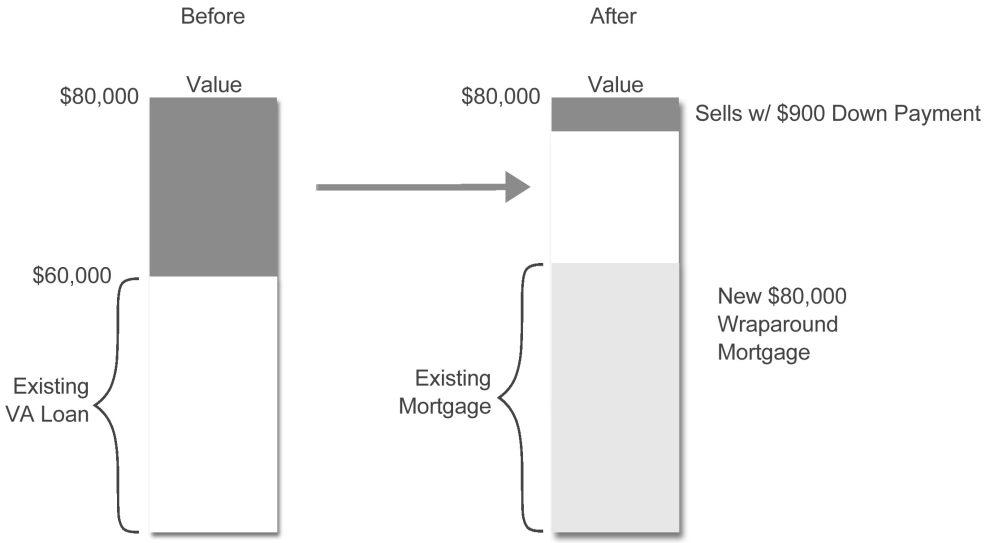
A properly drafted wraparound transaction will include at least four documents – a warranty deed, a wraparound deed of trust, a wrap note, and a wraparound agreement to address the details. There may also be a down-payment note involved. These are sophisticated documents that should be highly customized for the specific transaction. Only a qualified and experienced real estate attorney experienced in preparing wrap documents should be used to draft this paperwork. There are no forms available from any source that are adequate to the task. Also, because there is no TREC or TAR promulgated wrap addendum, the TREC earnest money contract should include an attorney-prepared custom addendum. Accordingly, attorney fees for wrap documentation may be somewhat more expensive than for the average closing.

Case Study: Buying Properties Post Forclosure

John Burley was a financial planner in the San Francisco area. After attending a Robert Allen seminar, he moved to Phoenix in the early 1990's. He began to buy VA foreclosures using a unique strategy. Rather than buying and holding each property, he immediately flipped each one.

Here was a typical deal: John purchased a home valued at $80,000 from the government's Veterans Administration (VA) in foreclosure for $60,000 with a small down payment. He then ran an ad in the newspaper offering to resell the home for $80,000 with only $900 down. This attracted many calls. John's profit came in the form of payments made on a wraparound mortgage that John would carry back, as shown in the illustration below.

This may not seem like much of a profit until you learn that John was buying and flipping four to five houses a month! He had purchased and flipped more than 800 homes in this manner. In each instance, he carried back a wraparound mortgage with monthly payments. His accumulated equities in these wraparound mortgages totaled millions of dollars, with a cash flow of tens of thousands of dollars per month. Admittedly, this took several years of concentrated dedicated effort, but you can't deny that it was a powerful way to create residual income.



How To Buy Real Estate Without A Bank Loan

Attachment 1

Several Attorney Opinions on the Due-On-Sales Clause

Due-on-Sale in Texas

by David J. Willis, J.D., LL.M.

Introduction

One consideration in using creative methods to convey real estate is whether or not such methods will enable a lender to accelerate the existing loan using the due-on-sale clause in the deed of trust. There are a variety of contractual and statutory factors that need to be considered. However, the fundamental fact is this: if a transaction involves a title transfer without prior consent of the lender, then the risk of acceleration (however small) is present if the lender's deed of trust contains a due-on-sale clause. And nearly all of them do. So the focus shifts from inquiring whether or not a lender can call a note due to how likely that is to take place.

Historically and generally speaking, mortgage lenders are not interested in foreclosing upon a performing loan on merely technical (non-monetary) grounds such as transfer of title by the borrower. However, some will send irate letters demanding that the new owner apply and qualify to assume the loan, threatening that the property will otherwise be posted for foreclosure. Whether or not that threat is real or just a bluff may be gamble, depending on the deed of trust involved and the lender's practices in this area. The spread between the note rate and the current prevailing rate is also a factor. Even though acceleration of a performing note may be unlikely, it is nonetheless clear that acceleration can happen. The acceleration risk cannot be reduced to zero.

Due-on-Sale and Executory Contracts

Due-on-sale has become a more important consideration since lease-options, long a mainstay of residential investor portfolios, are now defined as executory contracts subject to burdensome restrictions and requirements. Especially problematic is Prop. Code section 5.085(b)(3)(C) which requires in the case of an executory contract that "the lienholder consents to verify the status of the loan on request of the purchaser and to accept payment directly from the purchaser if the seller defaults on the loan." This means that the lienholder must be informed of and consent to an executory transaction, which is unlikely to ever occur as a practical matter. Accordingly, residential executory contracts longer than 180 days are effectively limited to paid-for properties. Residential investors owning property subject to a lien now tend to look to other alternatives—wraparounds, land trusts, or leases with a right of first refusal—all of which still require consideration of due-on-sale.

Due-on-Sale and Non-Executory Contracts

Property Code section 5.016 attempts to deal with the issue of due-on-sale by (1) requiring seven days' notice to the buyer before closing that an existing loan is in place; (2) giving the buyer this same seven-day period in which to rescind the contract to purchase; and (3) also requiring that a seven-day notice be sent to the lender, theoretically giving the lender an opportunity to accelerate and call the loan due. Lender consent is not required by this section. Clearly, this statute is designed to discourage transaction structures that separate title from debt and result in a lender losing control over a loan. Still, there is nothing illegal or even unethical about doing this.

It happens often, most notably in "subject to" and wraparound transactions.

Section 5.016(c) lists 11 express exceptions to the seven-day notice rule:

(c) This section does not apply to a transfer:

1. under a court order or foreclosure sale;
2. by a trustee in bankruptcy;
3. to a mortgagee by a mortgagor or successor in interest or to a beneficiary of a deed of trust by a trustor or successor in interest;
4. by a mortgagee or a beneficiary under a deed of trust who has acquired the real property at a sale conducted under a power of sale under a deed of trust or a sale under a court-ordered foreclosure or has acquired the real property by a deed in lieu of foreclosure;

5. by a fiduciary in the course of the administration of a decedent's estate, guardianship, conservatorship, or trust;
6. from one co-owner to one or more other co-owners;
7. to a spouse or to a person or persons in the lineal line of consanguinity of one or more of the transferors;
8. between spouses resulting from a decree of dissolution of marriage or a decree of legal separation or from a property settlement agreement incidental to one of those decrees;
9. to or from a governmental entity;
10. where the purchaser obtains a title insurance policy insuring the transfer of title to the real property; or
11. to a person who has purchased, conveyed, or entered into contracts to purchase or convey an interest in real property four or more times in the preceding 12 months.

The most obvious available exception between non-family members is a transaction where title insurance is issued (an odd exception, actually, since it was never the purchaser's title that was in doubt).
Transfers into a trust do not constitute an exception, although transfers by an existing trustee are excepted. So creating a land trust is not a means around the seven-day notice requirement.

No time period is specified during which a lender must act on the notice, if at all. The actual effect of this statute remains to be seen, particularly since the only sanction is to allow a prospective purchaser to back out of a contract before closing (not after).

Effect of the Mortgage Fraud Act

The Residential Mortgage Fraud Act requires virtually anyone connected with a real estate transaction (including real estate brokers, mortgage brokers, escrow officers, attorneys, etc.) to report to an authorized government agency suspicious activity that may involve real estate fraud. Tex. Gov't Code § 402.031. Question: Is failure to give the seven-day notice required "suspicious?" Future cases may answer this question in the affirmative. While Property Code section 5.016 may be largely toothless, fraud sanctions can be severe. Accordingly, as a matter of best practice, the seven-day notice should be given unless there is a specific statutory exception available.

The Wording of a Due-on-Sale Clause

Even if seven-day notice must be given, it is not necessarily true that a lender will accelerate and foreclose; nor is true that a lender always may take such action. As noted above, lenders are generally loathe to accelerate a performing loan.

The wording of a due on sale clause is critical in this context, and one should carefully examine the deed of trust before transferring title to property without the lender's permission. Take a look, for instance, at the language of the Fannie Mae/Freddie Mac Uniform Deed of Trust, which is the instrument most commonly used to secure institutional residential loans. It contains the following due-on-sale clause:

18. Transfer of the Property or a Beneficial Interest in Borrower. As used in this section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser. If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may [italics added] require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

Conveying title without lender consent is not a crime or a "violation" of this clause. It only provides that the lender "may" choose to accelerate the loan if the borrower does so. Secondly, paragraph 18 expressly states that a lender may not act if such action is "prohibited by Applicable Law." What is that? In a nutshell, it is a federal law that allows transfer of the property to a family living trust (see below).

The FHA deed of trust is worded differently:

9(b) Lender shall [italics added], if permitted by applicable law . . . and with the prior approval of the Secretary, require immediate payment in full of all sums securing this instrument if: (i) all of part of the Property, or a beneficial interest in a trust owning all or part of the Property, is sold or otherwise transferred (other than my devise or descent, and (ii) the Property is not occupied by the purchaser or granter as his or her principal residence. . ."

Transfer to a Living Trust - the Exception Provided by "Applicable Law"

The federal Garn-St. Germain Depository Institutions Act, 12 U.S.C. § 1701j-3, is among the "applicable law" that limits lenders' ability to act in matters of due-on-sale:

(d) Exemption of specified transfers or dispositions

With respect to a real property loan secured by a lien on residential real property containing less than five dwelling units, including a lien on the stock allocated to a dwelling unit in a cooperative housing corporation, or on a residential manufactured home, a lender may not exercise its option pursuant to a due-on-sale clause upon—

(1) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;

(2) the creation of a purchase money security interest for household appliances;

(3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;

(4) the granting of a leasehold interest of three years or less not containing an option to purchase;

(5) a transfer to a relative resulting from the death of a borrower;

(6) a transfer where the spouse or children of the borrower become an owner of the property;

(7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;

(8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or

(9) any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board.

Subsection (8) usually gets the most attention. This exception was intended to allow individuals to create family trusts for estate planning purposes, especially probate-avoidance, without worries about due-on-sale.

Are Land Trusts a Solution to Due-on-Sale Risk?

Subsection (8) is also the exception relied upon by many investors who use land trusts with the intention of avoiding the applicability and enforceability of due-on-sale. As stated above, this was not the purpose of the exception; however, setting that point aside, there remain an obvious pitfall to this approach: such trusts make use of a lease, lease-option, or other document allowing the buyer/beneficiary to move into the property immediately—which clearly "relates to a transfer of rights of occupancy." So while land trusts may in the right circumstances be effective creative vehicles, it cannot be claimed that they are a surefire method of dodging due-on-sale under Garn-St. Germain.

Other "applicable law" exists. For instance, the FDIC has promulgated 12 C.F.R. § 591.5(b)(1) which is unfortunately even more restrictive than Garn-St. Germain. It requires that in order for a land trust to avoid enforcement of a due-on-sale clause, the property must continue to be owner-occupied—something which is almost never true in

the typical case. This rule reads:

§ 591.5 Limitation on exercise of due-on-sale clauses.
(b)(1) A lender shall not (except with regard to a reverse mortgage) exercise its option pursuant to a due-on-sale clause upon:
(vi) A transfer into an inter vivos trust in which the borrower is and remains the beneficiary and occupant of the property, unless, as a condition precedent to such transfer, the borrower refuses to provide the lender with reasonable means acceptable to the lender by which the lender will be assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy.

Investor and seminar gurus often make extravagant claims that their complex and expensive forms provide immunity from due-on-sale issues, ironclad asset protection, expedited eviction in event of default, and other proprietary strategies that will lead an investor along the gold brick road to prosperity. Such claims are usually false. Few of these packages are customized for Texas, nor do they take into account the executory contract rules, violations of which are defined to be deceptive trade practices. Seminar guru forms can now get investors in real trouble.

Transfers to an Investor's Personal LLC

Transferring title of an investment property into an investor's personal company for asset protection purposes seldom results in the lender accelerating the note. In fact, this author has never seen that happen.
Note on Earnest Money Contracts

Consideration of due-on-sale begins with the earnest money contract, although TREC promulgated forms are less than adequate in dealing with the subject. It is a good idea to consult a real estate attorney to obtain a suitable special provisions addendum that addresses the non-standard nature of any creative transaction, including due-on-sale issues.

DISCLAIMER

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There's No "Due on Sale Clause" Jail
How to Take a Property Subject To An Existing Mortgage

by William Bronchick

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The "due-on-sale" clause is probably the most talked about, feared and misunderstood topic in real estate. This article will dispel any misunderstandings you may have about the due-on-sale and suggest a simple, yet effective strategy to get around it

What is the Due-On-Sale Clause?

Before we discuss how to get around the due-on-sale, we must understand what it is and where it came from. The due-on-sale (a.k.a "acceleration clause") is a provision in a mortgage document which gives the lender the right to demand payment of the remaining balance of the loan when the property is sold. It is a contractual right, not a law. This means that if title to the property is transferred, the bank may (or may not), at its option, decide to "call the loan due."

An "assumable" loan is one which is secured by a mortgage which contains no due-on-sale provision. FHA-insured mortgages originated before 12/89 and VA-guaranteed loans originated before 2/88 contain no due-on-sale provisions. Nearly all loans originated today contain a "standard" due-on-sale clause which usually reads something like:

"If all or any part of the property herein is transferred without the lender's prior written consent, the lender may require all sums secured hereby immediately due and payable."

Where Did the Due-on-Sale Dilemma Come From?

Banks began inserting due-on-sale clauses in their mortgages in the 1970s when interest rates rose dramatically. Home buyers were assuming existing loans rather than borrowing new money from banks because the interest rates on existing loans were lower. The banks used the due-on-sale as a way to kill their own worst competition. They argued that the reason for the restriction was to be able to police who was living in the property, the collateral for their loan. This argument holds little water, since most banks haven't been enforcing due-on-sale violations since the early 80's when interest rates were high. In fact, Black's Law Dictionary defines the due-on-sale clause as a device for "preventing subsequent purchasers from assuming loans with lower than market interest rates." This idea was also confirmed by the Court in Community Title Co v. Roosevelt Savings & Loan 670 S.W.2d 895 (Mo. App. 1984): "The due-on-sale clause was a way of eliminating these low yielding loans as soon as the property was sold, so that it could re-loan the money at current higher rates or negotiate a higher rate in the event the purchaser assumed the existing loan."

The homeowners fought the banks in court claiming that the enforcement of the due-on-sale was "unfair trade practice" and an "unreasonable restraint on the alienation of property." In state courts, many homeowners were winning the argument. See, e.g., Wellenkamp v. Bank of America, 21 Cal 3d 943 (1978). The banks ultimately won in a United States Supreme Court case, Fidelity Federal Savings and Loan Association v. de la Cuesta, 102 S.Ct. 3014, (1982). Congress thereafter passed the "Garn-St. Germain Federal Depositary Institutions Act" (12 U.S.C. 1701-j) which codified the enforceability of the due-on-sale clause, despite state statute or case law to the contrary.

There is No "Due-on-Sale Jail"

Many people are under the mistaken impression that transferring title to a property secured by a "due-on-sale" mortgage is illegal. This is because most lay people confuse civil liability with criminal liability. To be "illegal," you must be in violation of a criminal law, code or statute. There is no federal or state law which makes it a crime to violate a due-on-sale clause. If the lender discovers the transfer, it may at its option, call the loan due and payable. If it cannot be paid, the lender has the option of commencing foreclosure proceedings.

So the real question is: are you willing to take a property subject to a mortgage containing a due-on-sale clause with the risk of getting caught?

But, but . . . isn't It is Unethical or Fraud?

From a legal standpoint, a real estate agent who does not disclose the transfer to the lender has committed no breach of ethics. In fact, some of the standard contracts approved by the California Association of Realtors contain provisions contemplating a "subject to" transfer (see, e.g., form LRO-14, Residential Lease with Purchase Option). The Official Utah Division of Real Estate forms also contain provisions for transfers in the face of a due-on-sale provision. Form 3248, the "official" real estate contract used by New York Attorneys (jointly prepared by the New York State Bar Association, the New York State Land Title Association), contains a specific paragraph contemplating the buyer taking "subject to" and existing mortgage. There is a law in MI (Sec 445.1628) that does make it a crime for a licensed agent to help someone evade a due on sale, but it only applies to the long-gone "window period" loans (originated between January 5, 1977, and ending on October 15, 1982).

The state bars have no problem with lawyers helping clients conceal a transfer either. In Matter of Sabato, 560 N.E.2d 62 (Ind. 1990), the court found no ethical problem with an attorney helping a client circumvent a due-on-sale provision.

In Alaska Bar Association Ethics Opinion #88-2, the Committee declared, "circumventing a contract term under these circumstances is not fraud or fraudulent conduct. The attorney's participation would amount to concealing a breach of contract."

The Illinois Bar in Advisory Opinion No. 728 also concluded that an attorney helping a client evade a due on sale is not a crime, noting that: "The economic survival of a client may well depend upon failing to fulfill a contract."

The Virginia Bar reached a similar conclusion in Opinion 471 (1983): "There is no duty on the part of an attorney to advise the holder of the first deed of trust, who is not his client, that a violation of the terms of the deed of trust have occurred in a subsequent closing."

Thus, if it is not illegal or fraud for an attorney or broker to conceal a transfer of ownership, it is certainly not for a lay person. It is not a bad idea, however, for any party or real estate agent to disclose the existence of a due-on-sale clause to all parties involved in the transaction so that they are aware of the risk. Utah Rule R162-6.2.14 states "Real estate licensees have an affirmative duty to disclose in writing to buyer and sellers the existence or possible existence of a "due-on-sale" clause in an underlying encumbrance on real property, and the potential consequences of selling or purchasing a property without obtaining the authorization of the holder of the underlying encumbrance" (note that the rule does not prohibit such transactions).

In Ethics Opinion No. 96-2, the Alaska Bar ruled that an attorney has no duty to disclose the existence or the implications of a due-on-sale to parties to a transaction whom he was not representing (personally, I disagree

with this ruling; I think an attorney should disclose, even if it runs him the risk of giving out unsolicited legal advice).

"Federal" Fraud?

Some title company representatives and attorneys have refused to close "subject to" transactions, quoting 18 United States Code Section 1001, which generally states that:

"whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully – (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or(3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry; shall be fined under this title or imprisoned not more than 5 years, or both."

It is a bit of stretch to apply this law to concealing a transfer that triggers a due-on-sale clause. Taken to its illogical extreme, this statute could land you in jail for saying "I'm next" while on line at the post office when you really aren't. In fact, criminal statutes are always narrowly construed to protect the rights of citizens.

18 U.S.C. Sec. 1010 makes it a crime to make any false statement in regard to a loan insured by HUD. This law has been used to prosecute borrowers and their brokers who lie on their loan applications or "fudge" down payments for FHA loans. It has never been used to prosecute due-on-sale violators. In fact, the HUD-1 Settlement Statement (lines 203 and 503) that is used for virtually every loan closing has a blank which states, "loans taken subject to." How could a HUD-promulgated closing form contain such a blank if it were a crime to take property subject to an existing loan?

Remember that the due-on-sale is triggered by "transfers" other than a deed. A lease of three years or more or a lease with option to purchase (of any term) also gives the lender the option to call the loan due. Real estate agents routinely engage in lease/option transactions, and generally make the lease/option a compensable part of their listing agreements. In fact, REALTOR.com, the official website for the National Association of Realtors, contains thousands of listings for properties available by lease/option terms. It would be fair to assume that the large majority of these properties have underlying loans that would be triggered by the seller engaging in a lease/option transaction. Thus, if a lease with option triggers the due on sale, and real estate agents assist sellers in doing lease/options, then wouldn't hundreds of thousands of agents (as well as REALTOR.com) be engaging in fraudulent transactions?

To take it one step further, consider that major title companies routinely assist in closing "wraparound" transactions that also trigger due-on-sale clauses on underlying loans. So, these companies, their employees and their attorneys would also be guilty of conspiracy to commit fraud. Furthermore, attorneys, escrow agents and other parties to a transaction would also be guilty of conspiracy to commit fraud.

"Occam's Razor" is a scientific precept that postulates a simple theory: given two explanations, the simplest one is probably the right one. People have been taking over properties subject to existing mortgages for at least thirty years, and there have been no reported cases of criminal prosecution for hiding the transaction from a lender. So, have hundreds of thousands of investors, borrowers, real estate agents, title company employees and attorneys breaking the law for all these years and getting away with it, or is the practice of hiding a transfer from the lender a perfectly legal transaction? You decide!

Civil Liability?

In theory, a lender could sue the borrower for fraud for deliberately making a misstatement regarding the status of his loan. Of course, this makes no sense, because a lender would do better simply calling the loan due and foreclosing the property. Furthermore, a case for fraud requires someone to lie in the first place; keeping your mouth shut is the easiest way to avoid the issue. The case for fraud would be pretty hard to make, since the standard FNMA mortgage agreement does not state that the borrower has an affirmative obligation to notify the lender if he transfers title or any other interest in the property.

What if the borrower simply keeps his mouth shut and transfers title without making any statements to the lender?

This issue was addressed in a United States Supreme Court case, Field v. Mans, 1995.S.Ct.207 (1995). Defendant Mans bought a development property from Field, who carried a private mortgage on the property. Mans transferred title to an entity he and a new partner owned, then contacted Field to see if it was ok. In two written letters, Mans lied and told Field that he had not yet transferred title. Field refused permission without $10,000 compensation. Years later the real estate market tanked, Mans filed for bankruptcy and tried to absolve himself of the deficiency on the mortgage debt owed to Field. Field claimed that the "fraud" exception in the bankruptcy code would not allow the debt to be wiped out. The court agreed.

However, Justice Ginsberg, in his concurring opinion suggested that had the borrower kept his mouth shut, there would be no fraud and the debt would have been discharged. Justice Ginsberg cited the oral argument between the court and the lender's (Field's) attorney wherein the lender conceded that had Mans said nothing, there would be no fraud.

In theory, a lender could sue you, the buyer for fraud. In one such case, Medovoi v. American Savings & Loan, 89 Cal.App.3d 875 (1979) the court declared a lender could not sue the buyer for fraud for deliberately concealing a transfer, since he has no legal obligation to tell the lender of the transfer. Another theory is called "tortious interference with contract", that is, inducing the seller/borrower to breach his mortgage agreement. Oddly enough, I did find one reported case in which the lender tried to make such an argument: Community Title Co v. Roosevelt Savings & Loan 670 S.W.2d 895 (Mo.App. 1984).

In that case, a lender (Roosevelt Savings) sued a title company (Community Title) that advocated, educated and performed closings using a contract-for-deed. Some of the properties were encumbered by Roosevelt's mortgages, which contained due-on-sale provisions. The lender claimed that Community Title's actions "tortiously" interfered with the borrower's contractual obligation to Roosevelt. Roosevelt lost the case.

The court correctly reasoned that the title company was not liable, since the borrowers could have found some other means of violating the due-on-sale. In legal terms, there was no "but for" causation. The court noted that the lender could not prove that in a financially-distressed situation, the borrower was likely to pay off his mortgage in full rather than simply default. That's the reality of the business – why would someone hand you a deed subject to his mortgage if he could simple sell the property for all cash and pay off his loan? The reality is, a seller who does hand you over his property is out of options!

Another interesting point the court made in the Community Title case was that the lender had no standing policy on the enforcement of due on sale clauses. These days, most lenders will not call in loans because of the low-interest rate environment. Thus, a lender would have a very hard time proving damages, as in the Community Title case. The lender's only remedy is simply to call the loan due and foreclose on the property. A lender cannot seek a deficiency judgment against a borrower who takes subject to an existing loan and does not assume liability for it. Esplendido Apartments v. Metropolitan Condominium Assoc of Arizona, 778 P.2d 1221 (AZ 1989).

Don't Just Take My Opinion

The late Attorney Robert Bruss, a well-respected nationally syndicated real estate columnist, advocated the practice transferring properties "subject-to" existing loans without notifying the lender. In his 1998 article, "Nothing Down Home Purchases," Bruss says, "I buy subject to the existing mortgage and do not notify the lender of my purchase . . . In today's market . . . a lender would be crazy to push the issue and put the loan into default." In his article, "The Six Pillars of Assumption," he advocates the use of a land trust to avoid alerting the lender.

Attorney Jeffrey Liss, J.D., LLM, a Harvard Law School Graduate and well-respected member of the Illinois Bar, wrote an excellent article called "Drafting Around the Mortgage 'Due on Sale' Clause in the Installment Sale of Real Estate" that was published in the Chicago Bar Record. In this article he points out that "the mortgage does not prohibit the [transfer], but merely gives the mortgagee an option to accelerate. There is no duty upon the seller/mortgagor to report such a sale. The attorney, therefore, is not counseling any breach of contract or breach of a business relationship."

Laches

An equitable defense to the acceleration of the due on sale clause by the lender is called, "laches". Essentially you argue that the lender waived its right to enforce the due on sale by waiting too long. Remember, the due on sale is not automatically triggered – the lender must choose to enforce it, and by failing to do so for a long period of time, they may lose their right to enforce it. There's no particular "statute of limitations" for laches, but it is rather an equitable defense that can be argued and hopefully granted by a court in the case of a long wait for the lender to enforce the due on sale.

The Reality of the Marketplace

Buying a property subject to the existing mortgage loan is a risk versus reward gamble. The reward is that you avoid loan costs, personal liability for the note and conserve your cash. You can also take advantage of favorable interest rates, since an owner-occupied loan is likely going to have a lower interest rate than if you originated an investor loan. You can also get away with a lower down payment.

The legal risk was addressed above, but what is the practical risk? That is, what is the real risk of the lender calling in the loan? Nowadays, the risk is pretty slim. So long as the interest rate on the existing loan is within a few percent of market interest rates, the lender is not likely to accelerate a performing loan. The reason is simply profit; it costs money in legal fees to foreclose a mortgage, and the lender would rather get paid than have another non-performing loan on its books. Of course, if interest rates rose dramatically, lenders may start enforcing the due-on-sale clauses again. Interest rates don't jump several points overnight, so pay attention to the market if you have several properties acquired in this fashion. Consider refinancing the loans or selling the properties if market interest rates move upward.

Copyright © 2016 by William Bronchick. Host of Legalwiz.com he is a nationally-known attorney, author, entrepreneur, and public speaker. Mr. William Bronchick has been practicing law and investing in real estate since the early 90's, having been involved in thousands of real estate transactions. William Bronchick is the co-founder and past President of the Colorado Association of Real Estate Investors and the Executive Director and founder of the College of American Real Estate Investors. He is admitted to practice law before the bars of New York and Colorado.