SCOTT B. UMSTEAD, P.A.

ATTORNEY AT LAW

AGENT ON THE STREET

Episode 12: Seller Financing Considerations

Call from the Agent: I have been approached by a buyer who wants my seller to finance the purchase – can you help me understand what we should be thinking about?

The Response: Happy to -- I'm sure you know what seller-financing is, but it helps to always remember your client (the seller) is "the bank." I oftentimes get asked by sellers what will happen if the buyer doesn't pay the loan and the answer, at its core, is simple: you have the same remedies a bank has. At the most elemental level, the seller can foreclose the mortgage – this requires the filing of a foreclosure action and, at its conclusion, the Master-in-Equity will publicly auction off the property. I'll skip discussing how the bidding works, but if the high bid is insufficient to pay the debt, the seller can enter a "deficiency judgment" against the buyer. A deficiency judgment is a judgment in the amount of the difference between the total debt then due and the auction price.

With the foregoing in mind, my recommendation to sellers (presuming they're willing to entertain seller-financing) is to make sure the down payment is in an amount that will ensure a foreclosure sale will yield a sum sufficient to cover the debt. In discussions of this kind, we presume the worst will happen – the "worst" might be that the buyer doesn't make a single payment or maybe the worst is the discontinuation of payments after a year and foreclosing in a down market. I'll continue the discussion by using a couple examples:

Let's say the sale price is $100,000 and the sale price represents fair market value (which is usually true). If the buyer puts down $40,000 and asks the for seller-financing of $60,000, the seller is probably in good shape. After all, if the buyer doesn't make a single payment and the seller forecloses, the total debt will be $60,000, plus interest and foreclosure attorney's fees/costs (while it's possible the debt can climb a bit depending upon taxes and insurance, these are less common occurrences). So, in this example, the total debt might be $65,000. There's a very good chance the high bid will exceed this amount and, if it does, the seller gets paid 100% of the debt (the seller doesn't get to keep the excess).

For the next example, let's again presume a sale price of 100%, but this time the buyer asks that the seller finance the entire price. From the seller's standpoint, I don't like this deal at all. If the buyer doesn't make a payment, the debt will be at least $105,000 and a foreclosure auction probably isn't going to bring enough to pay the debt. Foreclosure sales aren't the "pennies on the dollar" some people still think they are, but a foreclosure sale price is usually some factor below the fair market value – for a standard property, I tend to use a 15% factor as a working figure. In this example, the seller would receive $85,000 – a full $20,000 shy of what is owed.

Some sellers like the idea of seller-financing because, in certain situations, it can give them a stream of income at an interest rate higher than what they can earn elsewhere and, so long as they're "secure" (meaning the debt-to-value ratio is favorable), they don't mind the possibility of foreclosure. Other sellers just want to get their sale proceeds at closing without involving themselves in a debtor-creditor relationship with a complete stranger – these sellers should not finance the buyer's purchase.

So far, I've been talking about the wisdom and maybe the desire to enter or not enter into seller-financing. If the seller is interested in seller-financing, there are a few financing elements to consider:

1. In the seller-financing addendum, it is both smart and appropriate to state the seller's attorney will prepare the loan documents at the buyer's expense. For whatever reason, I see contracts in which the buyer's attorney is to draft the documents – again, the seller is "the bank" and not one among us could go into a bank, ask for a loan and present the bank with our own loan documents for the bank to review. Very definitely, it makes sense to have the seller's attorney prepare the documents at the buyer's expense.
2. Seller-financing should not be considered if it will violate the Dodd-Frank Act. Good agents know to first ask "their attorney" if the particular seller-financing is subject to or excluded from the sinister sprawl of the Dodd-Frank Act. In my office, the minute a seller-financing contract is presented, it is given to me to determine whether it is subject to Dodd-Frank – the better offices make this a routine practice. As a matter of thoroughness, let me point out seller-financing that does fall under Dodd-Frank can still be done if it is handled by a "loan originator," but this goes beyond the scope of the episode.
3. Based on some popular questions I've been asked over the years, here are some helpful truths: A) there cannot be a provision stating the property title automatically reverts to the seller if the loan isn't paid; B) unlike a landlord-tenant relationship, the seller doesn't have a right to periodically inspect the property during the course of the loan; C) escrowing taxes and insurance isn't worth the trouble because there are other ways to make sure these things are paid and define consequences if they are not; and D) HOA dues is junior to the loan, so sellers really don't need to worry about it.

The logical follow-up question has already been asked, so the next episode will explain the keys to a good seller-financing addendum and provide examples/guides for use on the street.