

SCOTT B. UMSTEAD, P.A.

ATTORNEY AT LAW



Episode 13: Seller Financing Elements and Addendum Drafting

Call from the Agent: How do I write a seller-financing addendum?

The Response: The actual question and answer are intentionally omitted as well as the actual terms discussed, but seller-financing conversations are frequent and this episode is offered for the general benefit of our readers. Preparing a seller-financing addendum isn't difficult, but care should be taken to include all necessary terms or it may land the parties in an unpleasant squabble on the eve of closing. If a seller-financing addendum is incomplete or if the seller-financer later wishes he had included a certain requirement, most buyers aren't going to be willing to see the forgotten term in the loan documents and the transaction train begins to screech along the rails.

I begin with a list of basic elements for standard seller-financing and continue below with elements the seller may wish to consider (which may interest even the more experienced agents):

The Basic Elements:

Loan amount – I like seeing this stated as a dollar amount (ex. \$80,000) or at least as a percentage of the sale price (ex. “seller will finance 80% of the sale price”).

Interest rate – easy!

Amortization period/balloon payment – The amortization period is the period of time over which equal principal and interest payments are calculated. In a typical residential bank loan, the amortization period is 30 years. Most sellers won't want to wait anywhere near that long, but monthly payments can be amortized over 30 years and a balloon can be required in a shorter period – this makes the monthly payments more affordable for the buyer. For example, where a seller is financing \$80,000 and requires a balloon payment in 5 years, the monthly payments can be amortized over 30 years (\$429.46/mo) or 15 years (\$632.63/mo) or the amortization can be over the 5-year term itself (\$1,509.70/mo – this 5-year amortization would mean there is no balloon because the monthly payments over 5 years would satisfy the loan completely).

Prepayment penalty – Typically, seller-financers waive a prepayment penalty because they'd be happy to get their money sooner, but where it is waived, state “no prepayment penalty” in the addendum. Obviously, if the seller wishes to impose a prepayment penalty, the amount of the penalty or the method for its calculation should be stated.

Who drafts loan documents and who pays for it – In episode 12, I pointed to the logic of having the seller’s attorney draft the loan documents and requiring that the buyer pay for the drafting.

This makes a great deal of sense, but it isn’t required. Either way, the addendum should state who is to draft the documents and who is to pay for the drafting.

Grace Period/Late Fees – Any bank loan has a grace period and a late fee; seller-financing should have it too. A typical grace period is 5 to 15 days and a typical late fee is either a dollar amount (ex. \$50) or a percentage of the missed payment (ex. 5% of the amount of the late payment).

Title Insurance – If the seller will require the buyer to purchase “lender’s title insurance” insuring the seller’s collateral interest, state it in the addendum.

Lesser-Used Elements to Consider:

Default Interest Rate – Where a buyer/borrower is late on a payment, the interest rate can be increased if the increase is stated in the Note. This serves as an incentive for the buyer to keep the payments current and allows for some profit to the seller for having to put up with tardiness. For example, let’s say the loan rate is 5% with a 10-day grace period. The Note can provide that, if no payment is made within 15 days of its due date, the loan rate increases to 10% retroactive to the date of the missed payment. This would mean the interest rate stays at 10% for the life of the loan. I don’t necessarily believe every Note should have a default interest rate, but it is something to think about.

Method of Payment – Some sellers want the buyer to make payments electronically (i.e wire, auto-draft, ACH) as opposed to making payments by personal check. If the seller wishes to make a particular method of payment a requirement, it should be stated in the addendum.

Right to Cure – Some buyers may wish to be sent a “notice of right to cure” if a payment is missed. This “right to cure” gives them a period of time to bring the loan current and, if it is brought current within the cure period, the loan continues thereafter as if no tardiness had occurred. Even where a Note calls for a “right to cure,” it is typical that the buyer be entitled to only one (1) “notice of right to cure” – in other words, if the buyer is tardy a second time, the seller can proceed with loan enforcement without being required to send another “notice of right to cure.”

Personal Guaranty – If the buyer is an entity, the seller may wish to require the entity principal(s) sign a personal guaranty. This makes the principal(s) responsible for all loan obligations (meaning all obligations of both the Note and the Mortgage) if the entity does not meet the obligations. If you include a personal guaranty requirement, it’s best to personally name the guarantors in the addendum rather than referring to them generally as “entity principals.”

Every mortgage contains a homeowner’s insurance requirement, a “due on sale” clause, a requirement that property taxes be paid and, of course, foreclosure provisions. Therefore, these things generally do not need to be stated in the addendum.

Here's a nice basic addendum:

The seller will finance the sum of \$80,000 at 5% per annum. The loan will be secured by a first mortgage on the subject property. Monthly payments will be amortized over a 30-year term with a balloon payment of all principal and interest due 5 years from loan inception.

Payments shall be considered late if not received within 10 days of their due date and a \$50 late fee shall then be imposed. In the event any payment is not received within 20 days of the date it is due, the interest rate shall increase to 10% (default interest rate) retroactive to the date of the missed payment. There shall be no penalty for prepayments, whether in whole or in part. The loan documents shall be prepared by the seller's attorney and the charge for said preparation shall be borne by the buyer at closing.

Or you may prefer this format:

- Seller will finance \$80,000 at 5%
- Secured by first mortgage
- Payments amortized over 30 years
- Balloon payment in 5 years (full payoff)
- 10-day grace period for payments
- \$50 late fee
- 10% default rate if any payment is more than 20-days late
- No prepayment penalty
- Seller's attorney to prepare loan documents at buyer's expense

Here is some sample language for each of the lesser-used additional provisions mentioned above:

Default Interest Rate: If any payment is more than 20 days late, the interest rate shall thereupon be increased to 10% (default rate) and said increase shall be retroactive to the date of the missed/late payment. This is included in the sample addendum above, but the provision might not be considered standard, so I feel it belongs on the "lesser-used" list, as well.

Method of Payment: All payments shall be made by wire transfer to the seller. Contemporaneous with closing, the seller shall furnish the buyer all relevant wire information.

Right to Cure: In the event any payment is not received within the grace period, the buyer is entitled to one 15-day notice of right to cure. In the event of a second default, the buyer shall have no right to cure.

Personal Guaranty: The loan shall be personally guaranteed by Joe and Sally Schmidlap, jointly and severally.

If the seller-financing terms are "basic," they usually fit on the standard state contract addendum form. If, though, the seller financing terms are more involved, consider creating your own addendum in order to ensure clarity and completeness; seller-financing terms are and should be of central importance to the parties because they govern the continuing relationship, so there is no virtue in abbreviating the seller-financing addendum (clarity tends to ensure smoothness and harmony).

In our closings, we provide our seller-financers with a tip sheet containing important things they need to know about seller-financing so they're comfortable managing the debtor-creditor relationship after closing and know how to ensure their collateral interest (security interest) in the property is protected.