ALTERNATE FINANCING

OUTLINE:

Learning Objective: Upon completing this Section, brokers should have a better understanding of recent federal and state laws and rules impacting financing and lending practices and the extent to which these laws may apply to brokers or sellers who offer financing. Two of the most popular alternate financing methods, option contracts and installment land sales contracts, are reviewed.

INTRODUCTION

Several requests have been received to address the subject of alternate financing options, most of which involve some form of seller-financing. Lending requirements remain strict and qualifying for financing may be difficult for some buyers, particularly if they have experienced a short sale or foreclosure within the past five years. Even without such a blemish on their credit history, many purchasers may lack the liquid resources to pay a ten percent down payment as is often required these days by traditional lenders for a primary residence, and a twenty percent down payment for a second home or investment property.

What alternate financing options exist and are there any restrictions on either brokers or sellers who offer seller financing? As to the latter, yes, there are relatively new federal and state laws that may impact sellers who offer owner financing or who enter into lease with option to purchase agreements or contracts for deed as to residential property that will be occupied by the lessee/buyer as a principal dwelling. Thus, before discussing alternate financing methods, these materials will first briefly discuss the federal and North Carolina Secure and Fair Enforcement Mortgage Licensing Acts (the SAFE Acts), enacted in 2008 and 2009 respectively. The *2008 Federal law required each state to enact legislation meeting certain minimum standards* *regarding licensing and regulating loan originators who offer residential mortgages*. North Carolina enacted its version of the SAFE Act effective July 31, 2009, creating Article 19B in Chapter 53 of the General Statutes, and repealing the licensing and regulatory scheme for loan originators that had been in effect since 2002.

The General Assembly also passed legislation in 2010 that created two new chapters within the General Statutes defining for the first time by statute what an option to purchase contract executed with a lease agreement for residential property minimally must contain (new **Chapter 47G**), as well as defining the minimum contents of a contract for deed for residential property (new **Chapter 47H**). These new statutes will be discussed later. The same legislation that created these new chapters (SB 1015, 2009-2010 Session) also enacted new laws prohibiting Home Foreclosure Rescue Scams and declared violations of the Act to be an unfair trade practice.

APPLICABLE LEGISLATION/REGULATIONS

The Secure And Fair Enforcement Mortgage Licensing Acts (SAFE Act)

The Federal SAFE Act

The ***primary intent of the federal SAFE Act*** was to *enhance consumer protection and reduce fraud by requiring states to establish loan originator licensing or registration requirements for those individuals or entities extending residential mortgage loans made primarily for personal, family or household use*. All fifty states now have enacted legislation to comply with the federal mandate. The federal SAFE Act was administered by HUD through July 20, 2011, but all duties previously handled by HUD were transferred as of **July 21, 2011** to the new **Consumer Financial Protection Bureau (CFPB)** created by the Dodd-Frank Act. The federal Act also created a Nationwide Mortgage Licensing System and Registry (**NMLSR**).

The federal Act applies to and requires licensure for anyone "***engaging in the business of a loan originator***" which is defined as *one who in a commercial context (i.e., for compensation or gain)* ***habitually or repeatedly*** *takes a residential mortgage loan application and offers or negotiates the terms of a residential mortgage loan*. The federal Act allows States to enact additional legislation or rules that exceed the minimum requirements specified in the federal SAFE Act. The maximum penalty for violating the federal SAFE Act is a fine up to *$25,000 per violation*.

The federal Act *specifically exempts real estate brokerage activities from the SAFE licensing requirements* ***unless*** *the broker is compensated by a lender, mortgage broker or loan originator*. The federal Act does not specifically address how frequently a seller could provide financing before it would be deemed habitual or repeated, thus falling within the scope of the law, but the expectation is that the CFPB will look to reasonable state laws addressing that issue.

The NC SAFE Act

The North Carolina Secure and Fair Enforcement Mortgage Licensing Act became effective July 31, 2009 and is codified in Article 19B of Chapter 53 of the General Statutes. It replaces the loan originator licensing requirements enacted by the General Assembly in 2002 when North Carolina became one of the first states to require mortgage brokers doing business in North Carolina to register with the North Carolina Commissioner of Banks. According to the law:

> A primary purpose of this Article is to protect consumers seeking mortgage loans and to ensure that the mortgage lending industry operates without unfair, deceptive, and fraudulent practices on the part of mortgage loan originators...

The Act goes on to give the Commissioner of Banks “broad administrative authority to administer, interpret and enforce” the law which is to be “liberally construed” and to adopt rules implementing the law.

The intent and scope of the North Carolina Act is very similar to the federal Act in that it is directed at individuals who with the expectation of profit or gain, regularly accept residential mortgage loan applications or fund such loans or service such loans. A “***residential mortgage loan***” is a *loan made to a natural person primarily for personal, family or household use that is secured by a mortgage or deed of trust on a dwelling* located within this State or residential real estate on which a dwelling is or will be constructed. A “***dwelling***” under the Act is a *residential structure that contains one to four units*, regardless of whether it is attached to real property, and includes individual condominium units, cooperative units, manufactured homes, and mobile home or trailer if used as a residence.

Applicability to Real Estate Brokers

What is relevant to *real estate brokers* is that they are *specifically excluded* from the definition of “mortgage loan originator” ***so long as*** the broker does not become involved in the loan application process nor accept any compensation from a lender or mortgage broker or originator. **G.S. 53-244.030(21)(c)** reads:

> c. The term [mortgage loan originator] does not include: .....(2) A person or entity that only performs real estate brokerage activities and is licensed or registered as such in accordance with State law, *unless* the person or entity is compensated by a mortgage lender, a mortgage broker, or other mortgage loan originator or by any agent of a mortgage lender, mortgage broker, or other mortgage loan originator;

Subparagraph 28 of the same statute defines *real estate brokerage activity* as:

... any activity that involves offering or providing real estate brokerage services to the public, including:

a. Acting as a real estate agent or real estate broker for a buyer, seller, lessor, or lessee of real property;
b. Bringing together parties interested in the sale, purchase, lease, rental, or exchange of real property;

c. Negotiating, on behalf of any party, any portion of a contract relating to the sale, purchase, lease, rental, or exchange of real property, *other than in connection with providing financing with respect to any such transaction*;
d. Engaging in any activity for which a person engaged in the activity is required to be registered or licensed as a real estate agent or real estate broker under Chapter 93A of the General Statutes; and
e. Offering to engage in any activity, or act in any capacity, described in sub-subdivision a., b., c., or d. of this subdivision [i.e., above].

A licensee who only provides real estate brokerage services will not need to be licensed as a mortgage loan originator ***so long as s/he does not*** for compensation or gain or in the expectation of compensation or gain, whether through contact by telephone, by electronic means, by mail, or in person with prospective borrowers, ***either***:

1. Take a residential mortgage loan application or offer or negotiate terms of a residential mortgage loan,
2. Accept or offer to accept applications for mortgage loans,
3. Solicit or offer to solicit a mortgage loan,
4. Negotiate the terms or conditions of a mortgage loan, or
5. Issue mortgage loan commitments or interest rate guarantee agreements to prospective borrowers.

A real estate broker who engages in any of the foregoing acts with the expectation of compensation must be licensed as a mortgage loan officer. *May a broker act as the listing agent for a lender who holds title to property and receive compensation from the lender without being subject to the SAFE Act?* So long as the broker merely provides brokerage services, i.e., assists in the marketing and sale of the lender-owned property *and does not discuss loan terms or solicit loan applications*, the real estate broker should not need to be licensed under the SAFE Act. Note too that under the Act, an "individual" means a natural person, but the term "person" may refer to both individuals and entities, such as partnerships, limited liability companies, corporations, etc..

Applicability to Sellers

Thus, while real estate brokers are not impacted by the Act so long as they only provide brokerage services, *are there any constraints on seller financing*? Yes. **G.S. 53-244.040(d)** exempts property owners from licensure as a mortgage loan originator as follows:

(d) The following are exempt from all provisions of this Article ***except*** the provisions of **G.S. 53-244.111** [Prohibited Acts.]: ...

(2) Any individual who offers or negotiates terms of a residential mortgage loan with or on behalf of an immediate family member of the individual when making the family member a residential mortgage loan;

(3) Any individual seller who offers or negotiates terms and makes a residential mortgage loan secured by the dwelling that served *as the selling individual's residence*; .... or

(8) Any person who, as seller, *receives in one calendar year* ***no more than five residential mortgage loans*** *as security for purchase money obligations*, unless the United States Department of Housing and Urban Development has expressly and definitively determined that such persons are loan originators as the term is defined by §1503 of Title V of the Housing and Economic Recovery Act of 2008, Public Law 110-289, and such determination is in effect on July 31, 2010.

Thus, it appears that property owners may engage in seller financing 1) with *immediate members of their family* (defined as a spouse, child, sibling, parent, grandparent, grandchild, the spouse of any of the foregoing, and includes stepparents, stepchildren, stepsiblings and adoptive relationships), or 2) for the sale of their personal residence. Additionally, the General Assembly decided that an owner of property in North Carolina may offer financing on up to five properties in any calendar year without needing to be licensed as a mortgage loan originator. *An owner who seller finances* ***more than five*** *residential purchase money mortgage loans in any given calendar year will be subject to licensing under the Act*. Since HUD declined to establish a definite number of permissible seller financed transactions, it is anticipated that it, or now the Consumer Financial Protection Board, will defer to North Carolina's law that permits five such transactions per year.

Prohibited Acts

The list of **Prohibited Acts** that **no one may violate "...in the course of any residential mortgage loan transaction...**," even if otherwise exempt from the licensure requirements, is reprinted at the end of this Section. Some of the prohibited acts include:

- misrepresentation;
- violating State laws pertaining to permissible interest (NCGS Chapter 24), or Mortgages and Deeds of Trust (NCGS Chapter 45) or Cooperative Organizations (NCGS Chapter 54);
- not engaging in good faith or fair dealing or committing a fraud on any person in connection with the making or servicing of any mortgage loan;
- imposing a prepayment penalty if the principal amount of the loan is less than $150,000.00;
- failing to timely pay taxes or homeowner's insurance if escrowed; and
- failing to comply with certain notice procedures at least 45 days prior to initiating any foreclosure action.

Thus, a seller, in offering owner financing, may not misrepresent the terms of the financing, nor charge interest above that permitted by law, nor impose a prepayment penalty for early payoff if the principal amount of the loan is less than $150,000, nor fail to timely pay escrowed taxes or homeowner's insurance, etc.

Regulation Z and Truth-in-Lending Act Revisions

The Federal Reserve System issued rules in January 2011 amending Regulation Z and the Truth-in-Lending Act. The proposed rule prohibited a "creditor" from making a mortgage loan without first making a reasonable and good faith determination, based on verified and documented information, that the consumer has the ability to repay the loan. A "creditor" was defined as a person who regularly extends consumer credit that is payable by agreement in more than four installments. The proposal further defined "*one who regularly extends consumer credit" as one who extends such credit "**more than 5 times** for transactions secured by a dwelling in the preceding calendar year*." Thus, a person who seller finances fewer than five residential dwellings in any given year should not be subject to Regulation Z requirements because they would not be deemed a "creditor" under the Act. Nonetheless, there seems to be some question as to whether owners may be required to assess the borrower's "ability to repay" applying the same standards as regulated lenders when offering seller financing on a property. Developments are still unfolding.

ALTERNATE FINANCING ARRANGEMENTS

Two of the most common alternate financing methods are options to purchase, which may be a bare option or may be coupled with an initial lease period, and contracts for deed, also known as land installment sales contracts. As mentioned in the Introduction, *new state laws effective October 1, 2010 now govern both lease with option to purchase and contracts for deed when the subject property is residential and will be used by the lessee/buyer as his/her principal dwelling*. The requirements imposed by these new laws will be discussed at the end of each subsection, but the legal principles generally applicable to option contracts, lease with option to purchase contracts, and contracts for deed is discussed first within each subsection.

These materials are included for several reasons, the two most salient being the likelihood that a broker may more frequently encounter owners seeking financing options to move their property in the current environment, and to make brokers-in-charge aware for risk management purposes of the complexity of these types of contracts, the multitude of issues that may arise, the advantages and disadvantages of each to the seller and buyer respectively, and that there may be laws governing some of these transactions.

Real estate brokers should recognize when confronted with the prospect of such a transaction that the services of a licensed attorney will virtually always be required. There are no approved preprinted forms available to real estate brokers to utilize in such transactions, and to attempt to prepare a contract or language to be used in contracts for others may constitute the unauthorized practice of law if the person proposing the language is not a party to the transaction or a licensed North Carolina attorney. While one can easily find a purported lease-option "form" on the internet, one should use such forms only at one's peril, as it may not comply with North Carolina law nor adequately addresses the parties' needs. *Parties are always best served to seek legal counsel in such transactions*.

Most "lease-purchase" or "lease to own" or "rent to own" arrangements are actually leases with an *option* to purchase. If the lessee fails to fulfill his/her obligations under the lease terms, s/he often will not still be obligated to purchase (nor the owner remain bound to sell to the breaching lessee). Depending on the terms of the parties' agreement, a lessee who breaches the lease agreement and fails to cure the breach may lose the option to exercise the right to purchase even if the time within which to exercise the option has not expired.

Option to Purchase Real Estate

In a typical contract to convey real property, the seller of real estate is legally obligated to sell and the purchaser is legally obligated to buy. In contrast, an **option to purchase contract** (or **option**) *obligates the owner of real estate* (called the "**optionor**") *to hold an offer to sell open for a set period of time, but allows the other party to the option contract* (called the "**optionee**") *a legal right to either accept or not accept the optionor's offer to sell during the time period of the option.* Thus, the property owner is precluded from selling the property to anyone else during the option period or accepting an offer to purchase the property, other than in a back-up capacity, but the buyer has not committed to purchase the property.

Why would an owner of property bind oneself to sell in a contract where the other party is not legally bound to purchase? The answer is that *the optionee pays a fee or other valuable consideration for the option.* Indeed, there is some legal authority holding that if no consideration is paid, the option is an illusory contract that does not bind either party.

Do not confuse the separate and distinct "option to purchase" with the "option to terminate" feature found in the current residential standard Offer to Purchase and Contract form. The primary distinction between a traditional option contract and the standard Offer to Purchase is that in the latter case, the parties have a written contract wherein the seller agrees to sell and the buyer agrees to buy, even though the buyer has the unilateral right to change his mind within a certain time period and must notify the seller in writing if the buyer decides to terminate the existing contract. As noted above, in a *traditional option contract*, the seller has agreed to sell the property on certain terms for a stated period of time, but the buyer-optionee has not agreed to purchase the property. If the optionee decides to exercise the right to purchase the property on the previously agreed terms, then the optionee must affirmatively notify the seller that s/he is exercising the option and will commit to purchasing the property prior to the expiration of the optionee's option period.

Options have a very practical utility in the realm of real estate practice and best serve buyers who want a legally enforceable right to purchase property at some point in the future. The optionee-buyer pays the property owner a negotiated and specified amount of money for the exclusive privilege of buying the property upon specified terms and conditions within a designated time period. In a traditional option contract, if no consideration has been paid, there is case law that holds that the option is invalid. When a valid option to purchase exists, the optionee is given the exclusive privilege of buying the property within the allotted time, for the price and upon the terms and conditions specified in the option contract.

Lease with Option to Purchase

The option to purchase has a number of other practical uses. One of the most common fact situations is where a lessee has negotiated an option to purchase as part of the lease agreement. This may occur in both residential and commercial contexts, but *when the lease agreement is for residential property to be used by the lessee as his/her principal dwelling and is executed in conjunction with an option contract to purchase that property, then that option contract and lease agreement will be subject to the provisions of newly enacted* **Chapter 47G** of the General Statutes which became effective October 1, 2010. This new chapter will be discussed following the discussion below of option contracts in general.

Elimination of Standard Form Option to Purchase

While simple in concept, option contracts are often complex legal documents that can tie up title to real property and affect the rights of parties in significant ways. Because of this complexity and because "one size does ***not*** fit all" when it comes to option contracts, the former standard form "Option To Purchase" jointly approved by the North Carolina Bar Association and the North Carolina Association of REALTORS®, Inc. was discontinued as an approved form for use by licensees several years ago. Since there is no standard form, ***real estate brokers should advise sellers and buyers to obtain the services of an experienced real estate attorney when an option to purchase agreement is contemplated***.

Rights of Parties

An option does not give the optionee any title or legal interest in the property. The optionee merely has the opportunity to choose to accept a temporarily irrevocable offer by the optionor to sell the property.

> ***Example:*** An owner of a vacant lot gives Smith an option to purchase the lot for a period of 30 days in exchange for an option fee/consideration of $500 paid by Smith. The $500 is to apply toward the total purchase price of $10,000 in the event Smith exercises the option. During the 30-day option period and without the owner's knowledge, Smith hires a contractor to perform certain excavating work on the vacant lot. Smith ultimately decides not to exercise the option to purchase and also neglects to pay the contractor for the excavating work. The contractor promptly files a lien on the vacant lot to secure payment for the work performed. Under these facts, the contractor does not have a valid lien on the vacant lot since Smith had no legal interest in the property during the option period. Smith only had a right to obtain an interest in the property by exercising the option.

*The optionor, by granting an option to the optionee, gives up **both** the right to sell the property to anyone other than the optionee during the specified time period **and** the right to withdraw the offer to sell to the optionee prior to the expiration of the option period. The optionee has the exclusive right to exercise the option and purchase the property during the stated option period, but only upon the terms and conditions set forth in the option contract. The optionee cannot change the contract terms in any way upon exercise of the option without the mutual consent of the optionor.*

Understand, however, that the validity of the existing option contract is not endangered by further negotiations. In fact, one advantage of obtaining a valid option contract is that *negotiations during the option period do not affect the optionor's continuing offer to sell at the originally stated option price. The optionee may make an offer to buy on different terms than those stated in the option* ***without giving up the right to exercise the option***.

> ***Example:*** Brown, an owner of property, agrees to grant Smith a 60-day option to purchase Brown's property for a total price of $80,000 cash. All essential terms are contained in a well-drafted option agreement. During the option period, Smith notifies Brown that credit is extremely tight and that Smith would like to offer Brown $75,000 for the property with Brown taking back a second mortgage for $25,000 of the price. Brown flatly rejects this proposal and claims that the option has ended because of Smith's "counteroffer." Brown is incorrect. Subsequent negotiations during the option period will not alter the validity of the original option (unless, of course, the parties mutually agree to an amendment).

Options Must Be in Writing and Should Be Recorded

An option to purchase must be in writing to satisfy the Statute of Frauds. In addition, *the option should be recorded if the optionee wants to be protected from third party claims from persons who may deal with the owner-optionor and who are unaware of the outstanding option.* To secure the protection of the recording statutes, the option must be legally acknowledged before an appropriate officer.

The legal formalities of drafting an option are the same as those for all contracts and documents involving real property. When the property is owned by the entireties, then, as with other real estate contracts, the signatures of both tenants by the entirety are necessary to make the option effective.

Consideration

There are two types of consideration involved in an option. One is the consideration paid by the optionee to the optionor for the option itself. The other type of consideration involved in an option is the price the optionee must pay in order to purchase the property. *Both monetary amounts, the amount paid by the optionee for the option and the price to be paid if the optionee elects to exercise the option and consummate the purchase, should be definitely and separately stated in the option.*

For instance, the option may provide that the optionee is to pay $2000 to the optionor for the option itself and that the optionee will pay $120,000 if the optionee elects within the specified period to purchase the property. The option contract also should state whether the consideration paid for the option is to be applied toward the purchase price in the event that the option is exercised.

Other Option Contract Provisions

Purchase Price & Financing Terms

The **total purchase price** the optionee agrees to pay if the option is exercised, together with **terms regarding the method of payment**, should be clearly delineated. If a part of the purchase price relates to necessary financing, then the interest rate, maturity date, and terms of payment should be clearly stated, as well as any forfeiture provisions in the event of any default. As with contracts to convey in general, the option should describe the quality of **title** to be conveyed, including any reservations or exceptions desired by the optionor.

Option Period

The **duration of the option** (i.e., the "option period") should be stated precisely in the option contract, as it determines the time during which the optionee may elect to exercise the option and purchase the property. Typically, ***time is of the essence with respect to the option period and exercise of the option***. Given the strict "time is of the essence" standard, an experienced real estate attorney will specify both the date and the time at which the option is to expire. That attorney will avoid language such as "sixty days from the date hereof" or "for three months from today" as these descriptions can lead to disputes over the final date that the option can be exercised. Specifying both the date and time eliminates misunderstandings concerning the expiration of the option period.

Notice of Exercise

The **manner of notification** to the optionor that the optionee elects to exercise the option and purchase the property is an important provision. An option must be exercised in accordance with the terms of the option contract. The various methods of acceptable notification and to whom should be described in a properly drafted option contract, i.e., parties directly and/or their agents, via what specified methods? Note that it will *not* be sufficient to send notice on the final day of an option period by regular first class or next day delivery express mail, since ***the option must be exercised*** **prior** ***to expiration of the time period*** and a notice mailed on the last day but not received until after expiration of the option period is legally inadequate. ***Contrary to the general mailbox rule for communication of contract acceptance, a mailed notice of option exercise is <u>not</u> effective as of the date of mailing or postmark***.

In addition to language related to exercise of the option, some option contracts require an additional payment of money to accompany the exercise of the option or even a tender of the full purchase price. The leading North Carolina Supreme Court decision on this issue states the rule of law, in part, as follows:

> . . . Whether tender of the purchase price is necessary to exercise an option depends upon the agreement of the parties as expressed in the particular instrument. The acceptance must be in accordance with the terms of the [option] contract. Where the option requires the payment of the purchase money or a part thereof to accompany the optionee's election to exercise the option, tender of the payment specified is a condition precedent to the formation of a contract to sell unless it is waived by the optionor. On the other hand, the option may merely require that notice be given of the exercise thereof during the term of the option. [See *Kidd v. Early*, 289 N.C. 343, 222 S.E.2d 392 (1976).]

The all important lesson is a basic one: ***Notification of exercise of the option must be made in the time and manner specified in the option contract unless the optionor waives the provision***.

Quality of Title & Prorations

The option contract should provide for the **form of conveyance** by which the optionor is to convey title and the **type of title** the optionor must convey. Obviously, it is in the optionee's best interest that the option contract require conveyance by general warranty deed of a fee simple title free and clear of all encumbrances. The option should allow the optionee-purchaser a certain period of time after the election to purchase (exercise of the option) to have title to the property examined before closing the transaction. It also is good practice to include a **prorations** provision in the option contract stating how taxes, assessments, insurance, and similar matters are to be prorated between the parties at closing following the exercise of the option.

Assignment

Unless there is an express provision in the option contract to the contrary, *options may be assigned by the optionee to a third person*, thereby giving the third person the right to exercise the option and purchase the property. *The right to exercise the option is also inheritable.*

> ***Example:*** The owner of a 160-acre parcel grants Smith an option to purchase which is to run from October 1, 2011 to 6:00 p.m. Eastern Standard Time on October 31, 2011. Smith pays $10,000 as consideration for the option and the parties specify that the $10,000 is to apply toward the purchase price if the option is duly exercised. On October 20, 2011, Smith assigns his rights as optionee to Jones for $20,000. Absent a provision to the contrary in the option contract, the assignment is valid and enforceable by Jones. The original owner ("optionor") does not have to consent to the assignment. Smith has reaped a $10,000 profit in this transaction.

Thus, if the optionor desires to prevent the optionee from assigning the option contract, the optionor should specifically restrict assignment in the option agreement. Occasionally, nonassignability is implied under contract law. If the terms of the option clearly indicate that it was entered into in reliance on the personal integrity, skill, or credit of the optionee, it may be held nonassignable even in the absence of a provision restricting assignment. An example might be where the optionor will be providing seller financing for the optionee-purchaser. However, to avoid disputes and litigation and to eliminate all doubt, a nonassignability clause should be included in the agreement, if it is important to the seller.

Legal Description

Options should not be too informal or sketchy. If the option is to be of any value to either the prospective seller or buyer, it should reflect the *complete agreement* between the parties. A full and adequate **legal description of the property** that is the subject of the option should be included. Options are often declared invalid as a result of legally deficient descriptions.

> ***Example:*** Brown grants to Black an option to purchase property described in the option contract as: "200 acres of timberland near Smith's property in Harnett County." The option agreement is void under the Statute of Frauds, since the legal description is hopelessly ambiguous. There may be hundreds of Smiths who own property in Harnett County. Even if the correct Smith can be located, the precise shape and location of the optioned property still cannot be determined from this patently ambiguous description.

Comments

An expertly drafted option contract will cover all material terms that must be included to make a valid and binding contract. *The importance and complexity of option contracts dictates* *that* ***an experienced real estate lawyer be retained to prepare them***. One mistake occasionally made when laypersons attempt to draft option contracts is to avoid deciding on a definite price to be paid for the property in the event the option is exercised. In these poorly drafted agreements, the parties agree that the optionee shall have the option to purchase the property "at a price to be mutually agreed upon by the parties." This kind of price provision is meaningless because either party may decide not to agree for any or no reason at all. Thus, *the price that ultimately will be paid must be determined and specified at the time the option is prepared.* Similarly, an agreement that the purchase will be made at "current fair market value" is an invitation to legal controversy and disagreement and should be avoided.

Lease with Option to Purchase

The foregoing discussion applied to option contracts in general. However, as noted, options frequently may be coupled with a preceding lease term, perhaps more often in the past in commercial lease transactions, but with increasing incidence in today's market in residential transactions. There are no North Carolina laws at present dictating minimum terms or conditions that must be addressed in a commercial lease with option to purchase transaction; the lessor-optionor and tenant-optionee are free to negotiate whatever terms are mutually acceptable and the rights and obligations of each will be governed by the terms of their written agreements.

However, ***when an option contract is entered into simultaneously with a lease agreement for a residential property that will be the principal dwelling of the lessee-optionee, new state laws effective October 1, 2010 will apply***. These new laws found in **Chapter 47G** of the General Statutes apply only to property in North Carolina on which structures designed principally for occupancy of from one to four families are or will be located and that will be used as the purchaser/lessee's principal dwelling. Chapter 47G does not apply to leases or options on commercial property.

Depending on the terms of the real estate broker's agency agreement with the owner or lessee/optionee as to services to be provided and compensation therefor, a broker who helps negotiate a lease-option transaction may ultimately be able to collect a fee for procuring the tenant, another fee if providing ongoing property management services during the lease period, and a third fee if the lessee-optionee exercises the option to purchase the property.

NCGS Chapter 47G: Leased Residential Property with Option Contract

> **NOTE:** the North Carolina Association of REALTORS® *strongly discourages* licensees from attempting to create a lease/option contract by cobbling together the standard residential rental agreement form with Standard Form 2-T, which is why the services of an attorney will be required to prepare the parties' agreement.

Typically, the lease-option agreement is for a specified period of time, often one to three years, but it may be for whatever period the parties agree. In some agreements, the lessee may pay a nonrefundable upfront fee to the owner for the option period, in addition to monthly rent payments during the lease term. The monthly lease payments may reflect present fair market rental value, or the parties may stipulate that the monthly payments are $x more than the fair rental value with the difference either being applied against the purchase price or credited as a down payment in the event the lessee exercises the option to purchase. If the excess is to be credited towards a down payment, rather than offset against the stated purchase price, the lessee may want a third party to hold those funds in escrow during the lease period. The agreement should also address who is entitled to the "excess" payments if the lessee does not elect to purchase the property.

As of **October 1, 2010**, new North Carolina laws apply to "***covered lease agreements***" defined as a "residential lease agreement that is combined with, or is executed concurrently with, an option contract..." for the *purchase of property on which a one-to-four family structure is located that will be* ***used as the purchaser's primary dwelling***. In such transactions, **G.S. 47G-2** requires that the lease-option contract be in writing and contain certain minimum terms or disclosures including:

- full names and addresses of all parties and the date each signs the contract;
- a legal description of the property to be conveyed;
- the sales price of the property and the amount of any option fee or other amounts to be paid by either party;
- all obligations imposed on the purchaser that, if breached, will trigger a forfeiture of the option;
- the time period within which the purchaser must exercise the option;
- a statement of the purchaser's right to cure a default, including the right to cure a default once in any 12-month period during the covered lease agreement; and
- notice in 14-point boldface type above the purchaser's signature that the *purchaser* (by law) has the *right to cancel* the option contract anytime *until midnight of the third business day following execution or delivery of the option contract, whichever is later*. [See GS 47G-2(c).]

If the purchaser decides to cancel the contract within three business days, then the statute requires the seller, within ten days of receiving the buyer's notice, to return to the purchaser any and all property exchanged or payments made by the purchaser, minus an offset of an amount equal to the fair rental value of the use of the property during the duration of the purchaser's possession, plus any amounts necessary to cover any damage caused by the purchaser beyond normal wear and tear. Interestingly enough, the statute requires the ***seller to record the option contract***, or a Memorandum of Option Contract, with the appropriate Register of Deeds *within five business days after contract execution*.

Residential Landlord-Tenant Law

Note that **G.S. 47G-3** expressly states that the ***landlord-tenant laws found in Chapter 42 of the General Statutes apply to covered lease agreements***. Thus, the lessor will be responsible for fulfilling all of a residential landlord's obligations under state law and the lessee will have the statutory duties of a residential tenant during the lease period until the lessee either exercises the option to purchase the property or the option expires.

The purchaser's option rights can only be forfeited if the purchaser has breached one or more of his/her express obligations set forth in the lease-option contract *and* the contract allows the seller to declare a forfeiture in the event of purchaser's breach. However, the seller must first provide the purchaser with a written notice specifying the purchaser's default, including the amount of any monies due if payments are in default, and the date by which any cure must be made to avoid forfeiture of the purchaser's interest, which date may not be less than 30 days from service of the notice. The law specifically allows the lessee-optionee the right to cure a default once every 12 months during the term of the lease. A lessor faced with a lessee who fails to cure a default under the lease terms and refuses to surrender possession of the premises must resort to the summary ejectment process found in Article 3 of Chapter 42 of the General Statutes. {available at www.mcga.state.nc.us and click on General Statutes on the right.}

Seller Default

In the event the *seller defaults* on a mortgage or other indebtedness secured by the property before the option period has run, the optionee may either exercise the option, or rescind the contract and receive back all monies paid, minus an offset for the reasonable rental value for the use of the property and any amounts necessary to compensate the seller for actual damage caused by the lessee, beyond normal wear and tear.

While violations of the Chapter generally constitute an unfair trade practice, the final sentence of the Chapter (GS 47G-7) states that "*individual homeowners* selling his or her *primary residence* directly to an option purchaser" will ***not*** be subject to liability under the unfair trade practices statutes.

Land Installment Sales Contract or Contract for Deed

An **installment land contract** (also known as a **land contract, land sales contract,** or **contract for deed)** *is a written agreement whereby real property is sold on the installment payment method with the seller retaining legal title to the property until all of the purchase price is paid or until some other agreed point in the timetable of payments.* An installment land contract has a dual legal personality. It is a contract by which the seller agrees to sell and the buyer agrees to buy, and it is also a financing device that can be used in place of a purchase money deed of trust or mortgage. Use of the installment land contract is common in some states, but has been relatively rare in North Carolina.

The relationship between seller (sometimes called "vendor") and buyer (sometimes called "vendee") under an installment land contract is substantially the same as that existing between a mortgagee and mortgagor under a mortgage or deed of trust. The seller is doing the financing and therefore is in a position analogous to a mortgagee. The buyer is under an obligation to pay the installment payments as they come due and is therefore in a position analogous to a mortgagor, although *the buyer does* ***not*** *have the same legal rights and protections afforded a mortgagor* under deed of trust foreclosure statutes.

Basic Characteristics

Contrast the installment land contract with Standard Form 2-T. The standard contract to sell is an interim device, a binder contract that defines the rights and obligations of seller and buyer up until the settlement date for the real estate transaction, at which time the deed to the property is delivered to the buyer. The buyer then normally executes a deed of trust to secure repayment of the funds he has borrowed to pay the purchase price.

The *installment land contract*, on the other hand, *defines the rights and obligations of the parties over a long period of time*. No deed passes at a closing, and the buyer has not paid the seller the purchase price before moving onto the property. *The buyer occupies the property under the terms of the land contract and makes installment payments until the buyer has eventually paid the entire purchase price or a predetermined percentage of the purchase price, at which time he or she obtains a deed to the property from the seller.* The installment land contract gives the **buyer *"equitable"* title** to the property and serves as a long-term financing device. The **seller retains *"legal"* title** until it is time to convey such title to the buyer under the terms of the contract.

There is no approved standard form in North Carolina for installment land contracts, *and it is* **never** ***appropriate to use Standard Form 2-T for an installment land contract.*** Most standard offer to purchase and contract forms are not designed to cover long-term financing arrangements and are inadequate and incomplete for that purpose. *Because the installment land contract is also a financing device, the parties should always be advised to consult with an attorney for legal advice and drafting expertise.* As is discussed below, there remain significant disadvantages to installment land contract financing from the vendee's perspective and there may be situations where a vendor's attorney would also advise against utilizing the land contract approach to financing.

The following examples are taken from the terms of payment paragraphs of typical installment land contracts and may help the reader to envision the nature of this type of contract. Note that *the following constitute only part of a complete installment land contract*.

Example of Land Contract Involving 20-Year Repayment Period

> The purchaser, in consideration of all the covenants and agreements contained in this land contract, agrees to purchase the real property described below, and to pay therefor to the seller the sum of $105,000 in the following manner: $5,000 at the execution of this land contract, and the balance of $100,000, together with interest on such portions thereof as shall remain from time to time unpaid, at the rate of 7 percent per annum, until paid in full. Said principal and interest shall be payable in 240 installments of not less than $770.82 per month, beginning on the 5th day of October, 2011.

Example of Land Contract with Payments Amortized Based on a 20-Year Period, But with a Balloon Payment Due After 5 Years

> The purchaser, in consideration of all of the covenants and agreements contained in this land contract, agrees to purchase the real property described below, and to pay therefor to the seller the sum of $105,000 in the following manner: $5,000 at the execution of this land contract, and the balance of $100,000, together with interest on such portions thereof as shall remain from time to time unpaid at the rate of 7 percent per annum, until paid in full. Said principal and interest shall be

> payable in equal monthly installments of $770.82 per month beginning October 5, 2011; provided, however, that the entire unpaid principal balance is due and payable on the fifth anniversary of this land contract.

In the first example above, the buyer will not actually receive a deed from the seller until the year 2031, after making installment payments for 20 years. In the second example, a balloon payment of the entire unpaid balance is required after 5 years even though the payments up until that time are amortized based upon a 20-year period. At the end of the 5-year period the buyer will have to refinance the purchase price, probably by a conventional deed of trust, in order to make the balloon payment. When the buyer pays the seller in full, the seller will convey title by deed to the buyer.

NCGS Chapter 47H: Contracts for Deed

Installment land sales contracts or contracts for deed are now governed by State law as of October 1, 2010 **if** the subject property will be used as the principal dwelling of the purchaser. The laws apply to real estate in North Carolina on which a one to four family dwelling structure is or has been erected that will be used as the purchaser's principal dwelling. The Act also applies to the sale of property on which a manufactured home used as the purchaser's principal dwelling will be situated. The Act defines a "***contract for deed***" as:

> An agreement ...in which the seller agrees to sell an interest in property to the purchaser and the purchaser agrees to pay the purchase price in five or more payments, exclusive of the down payment, if any, and the seller retains title to the property as security for the purchaser's obligation under the agreement.

G.S. 47H-2 contains a laundry list of 17 points that represent the ***minimum contents of a contract for deed for a principal dwelling***. Rather than listing all of these points, the statute is reprinted at the end of this Section following the NC SAFE Act excerpt. In addition to the obvious material terms, e.g., parties, property description, purchase price, interest rate, duration, etc., the statute also requires the contract for deed to state the purchaser's right to cure a default, and provisions indicating who is responsible for repairs to the property and payment of taxes, hazard insurance premiums, flood insurance premiums, and owners' association dues. If the property is encumbered by a lien, the amount of the lien and the amount and due date of any periodic payments must be included in the contract for deed.

Right to Cancel

As with a residential lease/option contract, the purchaser has the statutory right to cancel the contract within three business days following execution or receipt of a copy of the contract, whichever is later. If the purchaser elects to cancel, then the seller must return to the purchaser within ten days any property exchanged or payments made, less any offset for the fair rental value of the property for the period of the purchaser's possession and any sums required to repair damages to the property caused by the purchaser beyond normal wear and tear.

Seller Obligations

The law again requires the *seller* to record the contract for deed or a Memorandum thereof within five business days of execution. **G.S. 47H-5** also requires the seller to provide the buyer with an **annual accounting** stating the amount paid under the contract, the amount still due, the number of payments remaining, amounts paid for taxes and hazard insurance, any insurance proceeds received for property damage and how the funds were spent, and the outstanding balance of any lien secured by the property. Late fees may not exceed 4% of the payment due and the payment must be at least 15 days past due. Note too that G.S. **47H-6** imposes certain limitations on the seller's title and requires the following prominent warning (14 point, boldface, caps) to the purchaser prior to executing the contract if the property is encumbered by more than one lien:

> **THIS PROPERTY HAS EXISTING LIENS ON IT. IF THE SELLER FAILS TO MAKE TIMELY PAYMENTS TO THE LIEN HOLDER, THE LIEN HOLDER MAY FORECLOSE ON THE PROPERTY, EVEN IF YOU HAVE MADE ALL YOUR PAYMENTS.**

Default or Breach

If the purchaser defaults on any of his/her obligations specified in the contract, then the seller must provide written notice specifying with particularity all breaches/defaults claimed, and allow the purchaser not less than 30 days to cure the default(s). If the purchaser fails to cure the default and will not voluntarily surrender possession, the seller will need to consult an attorney regarding his/her legal options.

If a seller breaches his/her obligations under the statute to timely pay existing encumbrances, then the buyer has the right to sue for damages or rescind the installment land contract and recover all sums previously paid, minus an offset for the fair rental value of the property during the period of buyer's possession. The statute also allows the purchaser to sue for declaratory or equitable relief, and acknowledges that each has "... any other rights and remedies provided by law or equity." It also excepts a seller from liability under the unfair and deceptive trade practices act when selling his/her primary residence directly to a buyer. [See G.S. 47H-8.]

Advantages and Disadvantages

Discussed below are the advantages and disadvantages to sellers and buyers of using an installment land contract rather than the traditional approach involving transfer of title at closing coupled with a purchase money mortgage given by the buyer either to the seller or a lender.

<u>Advantages to Buyer</u>

The installment land contract offers a number of advantages to the buyer. The availability of an alternative means of financing during times of tight conventional money supply is one advantage. The down payment is often lower in installment land contracts than with conventional methods of financing. The closing costs can be lower, although the fact that this type of contract is not that common in North Carolina may produce added legal expenses. The *buyer also may be able to claim the usual tax advantages that owning real property brings.*

Disadvantages to Buyer

On the other hand, a number of disadvantages exist when a buyer goes the installment land contract route. Remedies can be harsh if the buyer defaults on installment payments. *Most land contracts give the seller the option of calling the entire amount of unpaid principal due and payable if the buyer defaults on even one payment. A buyer in default does have the legal right to exercise an "equity of redemption" and pay the unpaid balance (including any accrued interest and pre-payment penalties) in order to keep the property.* If the buyer cannot come up with the balance, then the buyer often loses all rights to the real estate and to all payments previously made. *The protections of the deed of trust foreclosure statutes generally are* ***not*** *available to the defaulting buyer.*

If the seller has a mortgage on the property the buyer is purchasing under an installment land contract and the seller defaults in his payments on that indebtedness, then the purchaser may lose the property, even though they are current in their payments to the seller, but will have the right to sue the seller for damages or rescind the contract, as mentioned above ***if*** the subject property is the principal dwelling of the purchaser. If not, then Chapter 47H does not apply. To ensure notice, the buyer should file a Request for Notice with the Register of Deeds and notify each lienholder that the buyer wants to receive notice in the event the seller defaults on any of his/her obligations.

Recordation

There is another major disadvantage to the buyer. Since the seller keeps legal title until some future date (often the date when the final payment is made), the title the owner ultimately delivers to the buyer may be encumbered or defective in some way for numerous reasons, both voluntary and involuntary. Special legal precautions need to be taken to protect a land contract vendee with regard to title. Specifically, *the installment land contract should be recorded in the Register of Deeds office immediately after execution in order to protect the buyer's (vendee's) interest from claims to the property by subsequent third parties*. Recall that the new North Carolina law requires the ***seller to record*** either a memorandum of contract or the contract for deed for residential property that is the principal dwelling of the buyer ***within five days of contract execution***.

If the buyer later decides to sell or borrow money on his or her interest in the property, s/he may encounter some legal and practical difficulties as an installment land contract vendee. In some instances, installment land contracts may not be freely assignable. Even where the installment land contract authorizes assignment, potential purchasers may shy away from this method of land transfer. Should the vendee under a land contract wish to pledge the property as security to borrow money, he or she may find that traditional lenders are reluctant to accept a vendee's interest in a land contract as collateral to secure the loan.

Advantages to Seller

The seller under an installment land contract may see a number of advantages in selling property by this method. Income tax advantages flowing from the installment sale of property may appeal to sellers who need tax relief. The seller still has bare legal title and holds the deed to the property as security. *If the buyer defaults, the seller may be able to both obtain clear title to the land once again and also retain all payments previously made by the buyer.* Finally, the installment land contract device may be the only viable way that the seller has of selling the real estate; i.e., the seller may have a buyer who can purchase only if this method of financing is used.

Disadvantages to Seller

One disadvantage to the seller is that a land contract is frequently characterized by a low down payment. Also, the purchase price is paid in installments instead of one lump sum. To a seller who needs money rather than a tax advantage, this installment method will be disadvantageous. While legal remedies most certainly favor the seller in the event of default by the buyer, the seller may encounter extensive legal fees and a time delay before he actually forecloses the buyer's rights under the land contract and clears the title of the potential cloud of an outstanding land contract.

Comments

Brokers may be approached by consumers who have heard about wonderful concepts such as "lease to own" or "rent to own." In reality, however the deal is presented, it most likely will be *either* a lease with option to purchase or a contract for deed situation. Most consumers are familiar with rent-to-own concepts where one has use and possession of some item so long as one pays the agreed periodic rental fee, and while the consumer has the option of returning the property at any time and stop making payments, if the consumer makes the payments for an agreed period of time, then s/he acquires ownership of the property. In real property, that arrangement is called a contract for deed. Brokers should understand that no matter how a particular transaction may be styled, if it involves a one-to-four family structure that will be used by the lessee/buyer as his/her primary residence and the owner and lessee/buyer enter into either a lease-option contract or a contract for deed, that contract will now be governed by and must comply with North Carolina state laws.

Assumable Loans

Assumption of Existing Mortgage

If/when interest rates start to rise, buyers who are financially able may prefer to assume the seller's mortgage if that mortgage is assumable and has an interest rate substantially lower than current rates. It also may be to the seller's advantage to accept this arrangement rather than insist on a cash sale because otherwise the property may not sell as quickly due to the reluctance of many potential purchasers to arrange new financing at higher interest rates.

Assumptions of existing mortgages were once a fairly common occurrence because older mortgage and deed of trust forms generally were silent on the subject of the assumability of the mortgage or deed of trust by a future purchaser of the property. This silence permitted a purchaser of mortgaged property to "assume" and agree to pay the mortgage indebtedness *without the consent of the lender*. When an assumption of an existing mortgage occurs, the legal liabilities of the parties involved may be summarized as follows: *The purchaser who assumes an existing mortgage becomes personally obligated to pay the mortgage debt.* Not only may the mortgage or deed of trust be foreclosed, but the buyer also is subject to legal action and personal judgment to satisfy the debt if s/he defaults on the payments.

It should be noted, however, that *even if the buyer of mortgaged real property assumes the responsibility to pay the mortgage indebtedness, the original borrower (seller) remains liable to the lender unless the lender releases him from liability.* So a seller of property who has a mortgage or deed of trust that is assumable without the consent of the lender should keep one important point in mind: Even after the assumption of the mortgage debt by the purchaser, the seller (the original mortgage debtor) remains potentially liable for payment of the debt along with the new owner. One solution to this problem is for the seller to ask the lender to sign a written "release" relieving the seller of future liability under the mortgage or deed of trust after it has been assumed. The lender may or may not be willing to agree to release the original debtor (seller) from liability on the note.

Effect of Due-on-Sale Clauses on Mortgage Assumptions

The rapid growth in the use of due-on-sale clauses in mortgages over the past quarter century has caused mortgage assumptions to become relatively rare (except, perhaps, for FHA assumable loans). *In contrast to older mortgage and deed of trust forms, most current forms utilized by institutional lenders now contain a "**due-on-sale clause**" that has the effect of prohibiting the assumption of the mortgage or deed of trust by a purchaser of the mortgaged property without the lender's permission*. Generally, any transfer of legal title will trigger a due-on-sale clause requiring payment in full of the outstanding mortgage balance. Rarely, will the lender consent to a purchaser's assumption of an earlier mortgage or deed of trust carrying a substantially lower interest rate unless the purchaser agrees to pay a higher interest rate to the lender. As a practical matter, the lender who obtains a higher interest rate from the assuming purchaser probably will release the seller from further liability under the original indebtedness as part of the transaction. This assumes, of course, that the lender is satisfied with the credit worthiness of the assuming purchaser. *It is important to note, however, that the lender is not legally required to release the original debtor after consenting to the assumption by a new purchaser*. Thus, a prudent seller might make any proposed sale involving assumption of the seller's mortgage conditional upon the seller being released by the lender from further liability under the assumed mortgage.

Recent Developments in FHA Lending for Condominiums

Lastly, related to financing matters that may be of interest to brokers, is a July 2011 announcement by the FHA and its issuance of a "Consolidation and Update of Approval Requirements" that formalizes many of its requirements for FHA approval for condominium financing. It is estimated that 30-40% of all condominium mortgages are FHA-insured. Now, under the guidelines, to be eligible for FHA financing a condominium *minimally* must:

- have at least 2 units;
- no more than 25 percent of the property's total floor area or unit can be used for nonresidential/commercial purposes;
- no more than 10 percent of the units may be owned by any one investor or entity;
- all units must be 100 percent complete; and
- no more than 15 percent of units may be more than 30 days past due on association assessments (but an exemption can be requested in certain circumstances).

Another area impacting FHA financing was whether applicable condominium documents restricted an owner's ability to lease his/her unit which became an issue in 2008. This issue was clarified in the recent announcement as well. The result is that *FHA-insured financing may be used to purchase or refinance a condo unit even if Declaration of Condominium, bylaws, or governing documents restrict a unit owner's ability to lease their unit* ***so long as*** *the restrictions meet one or more of the following criteria*:

1. All leases must be in writing and subject to the Declaration and bylaws of the association.
2. The association may request and receive a copy of the sublease or rental agreement.
3. The association may request the name(s) of all tenants, including the tenants' family members who will occupy the unit.
4. Unit owners are prohibited from leasing their units for an initial term of less than 30 days.
5. The condominium association may establish a maximum allowable lease term, e.g. six months, twelve months, etc.
6. The condominium association may establish a maximum number of rental units within the project; however, the percentage of rental units may not exceed the current FHA condominium project owner-occupancy requirement (owner-occupancy ratio must be at least 50 percent).

NOTE: ***The association may not require that a prospective tenant be "vetted" or approved by the association or it agents (including as to creditworthiness)***, and any such current provision will almost certainly jeopardize FHA financing.

Thus, any condominium association that is considering implementing leasing restrictions should consider the foregoing guidelines and tailor the restrictions to comply with these guidelines if the association wishes to remain eligible for FHA insured financing. Further, associations who already have leasing restrictions should reconsider those restrictions in light of these recent guidelines and decide whether to amend its restrictions to conform to the new guidelines in order to remain eligible for FHA insured financing.

Less Desirable or Unlawful Financing Alternatives

Wraparound Mortgages

While not very common over this past decade with the attendant low mortgage interest rates, in the past an unusual type of mortgage arrangement called a **"wraparound mortgage"** occasionally was used during times of relatively high interest rates when a property owner with a first mortgage either wants to obtain additional financing or wants to sell his property to a buyer who needs or wants to avoid the current high interest rates. A wraparound mortgage is in actuality a second mortgage with an unusual twist that enables the borrower to obtain financing in addition to the existing first mortgage *without paying off the first mortgage* and without paying the high interest rates normally charged for second mortgages. Under this arrangement, *the amount of the second "wraparound" mortgage is the total of the outstanding balance on the first mortgage and the additional amount of money being obtained by the borrower as a result of the second mortgage*. The borrower makes mortgage payments only to the second mortgagee, who then continues to make the payments under the first mortgage to the first mortgagee. Thus, the second mortgage is said to "wrap around" the first mortgage. Perhaps this is best explained by use of an example.

> *Example:* A property valued at $200,000 has a first mortgage with a balance of $100,000 and an interest rate of 6%. The owner wants to use his equity in the property to borrow an additional $75,000, but assume that current interest rates are about 8% for first mortgages and 10% for second mortgages. The owner, however, is able to arrange with a lender a second "wraparound" mortgage with a stated principal amount of $175,000 at 7% interest, with such mortgage providing that the owner-borrower would make payments on the $175,000 loan to the second mortgagee, who would then make the payments on the $100,000 first mortgage to the first mortgagee. The second mortgagee actually provides only $75,000 in cash to the owner. The owner obtains his needed additional funds at a lower than market interest rate. The lender providing the "wraparound" mortgage is willing to make the loan at such a rate because the lender will be earning, in addition to 7% on the $75,000 it is lending, 1% on the $100,000 first mortgage loan balance *without having to provide the $100,000 in cash*. Thus, the lender is receiving more than a 7% return on its investment.

The foregoing example demonstrates a practical use of the wraparound mortgage concept by an owner. A wraparound mortgage may be lawful in this case as there is no transfer in legal title to the property although there is now a second deed of trust. However, it is *extremely rare that a wraparound mortgage can lawfully be used in connection with the purchase of a property with an existing first mortgage*, as there is a transfer of legal title from the seller to the buyer. Most contemporary mortgage and deed of trust forms contain a "Due on Sale" clause that requires payment in full of the outstanding loan balance upon the seller transferring legal title to some person or entity, and most of these forms treat the wraparound arrangement as a "sale" for purposes of triggering the due-on-sale provisions. Thus, it is ***unlikely that wraparound mortgages will be used very frequently in connection with real estate sales***.

Sale Subject to Existing Mortgage

Another infrequent type of sale is the sale of land "subject to" an existing mortgage. When a real property sale specifically is made "subject to" the existing mortgage debt (or if no mention is made of an existing mortgage on the land) without any specific agreement by the buyer to assume the debt, the buyer of the land will *not* be personally liable for the debt or any deficiency if the sale of the land at foreclosure does not fully pay off the mortgage debt, even though the parties expected the buyer to make the installment payments. *Where a purchaser of land takes "subject to" a mortgage debt, or without the mortgage debt being mentioned, the debt can be satisfied only out of the land itself or by suit against the seller* (*the original borrower*) *and the purchaser of the mortgaged land does* ***not*** *become personally liable either to the mortgage creditor or to the seller*. Put another way, the purchaser who takes the land "subject to" the mortgage does not become personally liable to pay the mortgage debt because he has not expressly "assumed" the debt. The seller of the mortgaged premises remains the only one personally liable on the indebtedness. Since the seller cannot sue the buyer if the buyer does not pay the debt, such an arrangement certainly is not desirable from the perspective of the seller.

Transfers of property in which the buyer takes "subject to" an existing mortgage or deed of trust are extremely rare. When they do occur, it most commonly is because there is a valid pre-existing mortgage on the property that is unknown to the purchaser. While a purchaser in this type of situation may have legal recourse against the seller (assuming a warranty deed in which the mortgage was not excepted from the warranties of title) or may be able to recover under a title insurance policy if the defect is not excepted from coverage, the land nonetheless is subject to the mortgage and can be sold by foreclosure if the indebtedness is not paid when due. This is but one of many reasons why an adequate title search should be made before real property is purchased.

One final point. *Because of the popularity of due-on-sale clauses, transfers of property "subject to" an existing mortgage will not be possible under most contemporary mortgage and deed of trust forms without the consent of the lender*. As with a transfer wherein the purchaser assumes and agrees to pay an existing mortgage, a "subject to" transfer also will trigger the due-on-sale clause in most modern forms unless the lender's consent is obtained in advance. If consent is sought, a lender rarely will allow a "subject to" transfer and will prefer the existing mortgage be paid in full or possibly, in the case of a particularly creditworthy purchaser, that the purchaser assume and agree to pay the mortgage indebtedness.

Homeowner and Homebuyer Protection Act

The North Carolina General Assembly also passed the **Homeowner and Homebuyer Protection Act** in July 2010 which became effective October 1, 2010. This Act created a new Article within the Consumer Protection chapter regulating home foreclosure rescue scams. A brief overview of the Act and its requirements is provided as an alert and for informational purposes, even though persons engaging in home foreclosure scams hopefully will not be acting through a broker. A broker should be exceedingly cautious before agreeing to represent a prospective purchaser who wishes to engage in marginal transactions and should terminate representation if the buyer violates state law. Further, a broker may be subject to disciplinary action where the broker violates the statutes below when acting as a buyer.

Home Foreclosure Rescue Scams - G.S. 75-120 to 75-122

The statute defines a "foreclosure rescue transaction" as the transfer of residential real property that includes all of the following features:

- the real property is the principal residence of the transferor;
- the transferor is in default or foreclosure proceedings have been initiated;
- the transferee or others working in concert with the transferee represent that the property transfer will prevent, postpone or reverse the effect of the foreclosure and will allow the transferor to remain in the residence; and
- the transferor retains an interest in the property, including a tenancy interest, or an interest under a lease-purchase agreement, an option to reacquire the property, or any other legal, equitable, or possessory interest in the property conveyed.

Basically, the law makes it illegal for any person or entity to engage in a foreclosure rescue transaction for financial gain or the expectation of gain ***unless*** the transferee pays the transferor ***at least*** fifty percent (50%) of the fair market value of the property as determined by an appraisal conducted no more than ninety (90) days prior to the transfer. The appraisal is to be delivered to the owner of the property no less than seven days prior to the transfer. The statute also dictates the minimum terms of the parties' contract to convey. A violation of the statute (G.S. 75-121) constitutes an unfair trade practice and an aggrieved transferor may file a civil action for damages and to void the transaction. The only transferees who are not subject to the terms of the Act are:

- a member of the owner's immediate family (as defined in the NC SAFE Act),
- a state, federal or local governmental agency,
- a bank, savings institution or credit union, or
- a mortgage lender or mortgage servicer licensed under the NC SAFE Act.

NC SAFE Act:

G.S. §53-244.111. Prohibited acts.

In addition to the activities prohibited under other provisions of this Article, it shall be unlawful for any person in the course of any residential mortgage loan transaction:

(1) To misrepresent or conceal the material facts or make false promises likely to influence, persuade, or induce an applicant for a mortgage loan or a mortgagor to take a mortgage loan, or to pursue a course of misrepresentation through agents or otherwise.

(2) To improperly refuse to issue a satisfaction of a mortgage. NC General Statutes - Chapter 53 Article 19B 20

(3) To fail to account for or to deliver to any person any funds, documents, or other thing of value obtained in connection with a mortgage loan, including money provided by a borrower for a real estate appraisal or a credit report, which the mortgage lender, mortgage broker, mortgage servicer, or mortgage loan originator is not entitled to retain under the circumstances.

(4) To pay, receive, or collect in whole or in part any commission, fee, or other compensation for brokering or servicing a mortgage loan in violation of this Article, including a mortgage loan brokered or serviced by any unlicensed person other than an exempt person.

(5) To charge or collect any fee or rate of interest or to make or broker or service any mortgage loan with terms or conditions or in a manner contrary to the provisions of Chapter 24, 45, or 54 of the General Statutes.

(6) To advertise mortgage loans, including rates, margins, discounts, points, fees, commissions, or other material information, including material limitations on the loans, unless the person is able to make the mortgage loans available to a reasonable number of qualified applicants.

(7) To fail to disburse funds in accordance with a written commitment or agreement to make a mortgage loan.

(8) To engage in any transaction, practice, or course of business that is not in good faith or fair dealing or that constitutes a fraud upon any person in connection with the brokering or making or servicing of, or purchase or sale of, any mortgage loan.

(9) To fail to pay promptly when due reasonable fees to a licensed appraiser for appraisal services that are:

a. Requested from the appraiser in writing by the mortgage broker or mortgage lender or an employee of the mortgage broker or mortgage lender; and
b. Performed by the appraiser in connection with the origination or closing of a mortgage loan for a customer or the mortgage broker or mortgage lender.

(10) To broker a mortgage loan that contains a prepayment penalty if the principal amount of the loan is one hundred fifty thousand dollars ($150,000) or less or if the loan is a rate spread home loan as defined in G.S. 24-1.1F.

(11) To improperly influence or attempt to improperly influence the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan. Nothing in this subdivision shall be construed to prohibit a mortgage lender, mortgage broker, or mortgage servicer from asking the appraiser to do one or more of the following:

a. Consider additional appropriate property information.

b. Provide further detail, substantiation, or explanation for the appraiser's value conclusion.

c. Correct errors in the appraisal report.

(12) To fail to comply with the mortgage loan servicing transfer, escrow account administration, or borrower inquiry response requirements imposed by sections 6 and 10 of RESPA and regulations adopted thereunder.

(13) To broker a rate spread adjustable rate mortgage loan without disclosing to the borrower the terms and costs associated with a fixed rate loan from the same lender at the lowest annual percentage rate for which the borrower qualifies. NC General Statutes - Chapter 53 Article 19B 21

(14) To fail to comply with applicable State and federal laws and regulations related to mortgage lending or mortgage servicing.

(15) To engage in unfair, misleading, or deceptive advertising related to a solicitation for a mortgage loan.

(16) In connection with the brokering or making of a rate spread home loan as defined under G.S. 24-1.1F, no lender shall provide nor shall any broker receive any compensation that changes based on the terms of the loan. This subdivision shall not prohibit compensation based on the principal balance of the loan.

(17) For a mortgage servicer to fail to comply with the mortgage servicer's obligations under Article 10 of Chapter 45 of the General Statutes.

(18) For a mortgage servicer to fail to provide written notice to a borrower upon taking action to place hazard, homeowner's, or flood insurance on the mortgaged property or to place such insurance when the mortgage servicer knows or has reason to know that the insurance is in effect.

(19) For a mortgage servicer to place hazard, homeowner's, or flood insurance on a mortgaged property for an amount that exceeds either the value of the insurable improvements or the last known coverage amount of insurance.

(20) For a mortgage servicer to fail to provide to the borrower a refund of unearned premiums paid by a borrower or charged to the borrower for hazard, homeowner's, or flood insurance placed by a mortgage lender or mortgage servicer if the borrower provides reasonable proof that the borrower has obtained coverage such that the forced placement is no longer necessary and the property is insured. If the borrower provides reasonable proof within 12 months of the placement that no lapse in coverage occurred such that the forced placement was not necessary, the mortgage servicer shall refund the entire premium.

(21) For a mortgage servicer to refuse to reinstate a delinquent loan upon a tender of payment made timely under the contract which is sufficient in amount, based upon the last written statement received by the borrower, to pay all past due amounts, outstanding or overdue charges, and restore the loan to a nondelinquent status, but this reinstatement shall be available to a borrower no more than twice in any 24-month period.

(22) For a person acting as a mortgage servicer to fail to mail, at least 45 days before foreclosure is initiated, a notice addressed to the borrower at the borrower's last known address with the following information:

a. An itemization of all past due amounts causing the loan to be in default.

b. An itemization of any other charges that must be paid in order to bring the loan current.

c. A statement that the borrower may have options available other than foreclosure and that the borrower may discuss the options with the mortgage lender, the mortgage servicer, or a counselor approved by the U.S. Department of Housing and Urban Development (HUD).

d. The address, telephone number, and other contact information for the mortgage lender, the mortgage servicer, or the agent for either of them who is authorized to attempt to work with the borrower to avoid foreclosure.

e. The name, address, telephone number, and other contact information for one or more HUD-approved counseling agencies operating to assist borrowers in North Carolina to avoid foreclosure. NC General Statutes - Chapter 53 Article 19B 22
f. The address, telephone number, and other contact information for the consumer complaint section of the Office of the Commissioner of Banks.

(23) To fail to make all payments from any escrow account held for the borrower for insurance, taxes, and other charges with respect to the property in a timely manner so as to ensure that no late penalties are assessed or other negative consequences result regardless of whether the loan is delinquent, unless there are not sufficient funds in the account to cover the payments and the mortgage servicer has a reasonable basis to believe that recovery of the funds will not be possible. (2009-374, s. 2.)

§ 53-244.112. Criminal penalties for unlicensed activity.
Engaging in the mortgage business as defined by G.S. 53-244.030(11) or acting as a mortgage loan originator without a license as required by the provisions of G.S. 53-244.040 is a Class 3 misdemeanor. Each transaction involving unlicensed activity is a separate offense. (2009-374, s. 2.)

Excerpt from Chapter 47H: Contracts for Deed

§ 47H-2. Minimum contents for contracts for deed; recordation.

(a) Writing Required. – Every contract for deed shall be evidenced by a contract signed and acknowledged by all parties to it and containing all the terms to which they have agreed. The seller shall deliver to the purchaser an exact copy of the contract, containing all the disclosures required by subsection (b) of this section, at the time the purchaser signs the contract.

(b) Contents. – A contract for deed contract shall contain at least all of the following:

(1) The full names and addresses of all the parties to the contract.
(2) The date the contract is signed by each party.
(3) A legal description and the physical address of the property conveyed.
(4) The sales price of the property conveyed.
(5) Any charges or fees for services included in the contract separate from the sale price.
(6) The amount of the purchaser's down payment. NC General Statutes - Chapter 47H 2
(7) The principal balance owed by the purchaser, which is the sum of the amounts stated in subdivisions (4) and (5) of this subsection, less the amount stated in subdivision (6) of this subsection.
(8) The amount and due date of each installment payment and the total number of installment payments.
(9) The interest rate on the unpaid balance, if any, and the method of determining the interest rate.
(10) A conspicuous statement of any pending order of any public agency or other matters of public record adversely affecting the property, provided the seller has actual knowledge of the pending order or matter.
(11) A statement of the rights of the purchaser to cure a default.
(12) A statement setting forth the obligation of each party who is responsible for making repairs to the property, the payment of taxes, hazard insurance premiums, flood insurance premiums, homeowner association dues, and other charges against the property from the date of the contract.
(13) A provision that the purchaser has the right to accelerate or prepay any installment payments without penalty; unless the property is encumbered by a deed of trust as permitted by G.S. 47H-6 and the loan secured by the property contains a prepayment penalty, in which case the contract may specify that the purchaser will compensate the seller for the prepayment penalty.

(14) A description of conditions of the property that includes whether the property, including any structures thereon, has water, sewer, septic, and electricity service, whether the property is in a floodplain, whether anyone else has a legal interest in the property, and whether restrictive covenants prevent building or installing a dwelling. If restrictive covenants are in place that affect the property, a copy of the restrictive covenants shall be made available to the purchaser at or before the execution of the contract.
(15) A statement indicating the current amount of any real estate taxes and/or homeowner association dues, or special assessments required to be paid on the property, and the amount of such taxes, dues, or assessments that are delinquent. To the extent these amounts are not known at the time the contract is executed, a reasonable estimate shall be given.
(16) If the property being sold is encumbered by a deed of trust, mortgage, or other encumbrance evidencing or securing a monetary obligation which constitutes a lien on the property, and the seller is not a licensed general contractor within the meaning of Chapter 87 of the General Statutes, or a licensed manufactured home dealer within the meaning of Article 9A of Chapter 143 of the General Statutes, a statement of the amount of the lien, and the amount and due date, if any, of any periodic payments.
(17) A conspicuous statement, in not less than 14-point boldface type, immediately above the purchaser's signature, that the purchaser has the right to cancel the contract at any time until midnight of the third business day following execution of the contract, or delivery of the contract, whichever occurs later.

(c) Right to Cancel. – The purchaser may exercise the right to cancel the contract for deed until midnight of the third business day following execution of the contract for deed or delivery of a copy of the contract with the required minimum contents, whichever occurs later. If the purchaser cancels the contract, the seller shall, not later than the tenth day after the date the seller receives the purchaser's notice of cancellation, return to the purchaser any and all property exchanged or payments made by the purchaser under the contract minus an offset of an amount equal to the fair rental value of the use of the property during the duration of the purchaser's possession of the property plus an amount necessary to compensate the seller for any damages caused to the property by the purchaser beyond normal wear and tear.

(d) Recordation. – Within five business days after the contract has been signed and acknowledged by both the seller and the purchaser, the seller shall cause a copy of the contract or a memorandum of the contract to be recorded in the office of the register of deeds in the county in which the property is located. If a memorandum of the contract is recorded, it shall be entitled "Memorandum of a Contract for Deed" and shall contain, as a minimum, the names of the parties, the signatures of the parties, a description of the property, and applicable time periods as described in subdivisions (b)(8) and (11) of this section. A person, other than a seller and purchaser may rely on the recorded materials in determining whether the requirements of this subsection have been met. The seller shall pay the fee to record the document unless the parties agree otherwise.

(e) Effect of Forfeiture. – Upon default and forfeiture after proper notice of default and intent to forfeit and failure of the purchaser to substantially cure the default, the purchaser's equitable right of redemption shall be extinguished by:

(1) A mutual termination executed by the parties and recorded in the office of the register of deeds of the county in which the property is located, or
(2) A final judgment or court order entered by a court of competent jurisdiction that terminates the purchaser's rights to the property and extinguishes the equity of redemption. A certified copy of the order shall be recorded in the office of the register of deeds of the county in which the property is located pursuant to G.S. 1-228.

(f) [Instrument Ineffective.] – No instrument purporting to extinguish the equity of redemption that is executed as a condition of the transaction or prior to a default will be effective. (2010-164, s. 4.)