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Maylie & Grayson is a full service law firm providing representation to real estate brokerages, licensees, Realtor® associations, developers, builders, lenders and investors, providing services in all aspects of real estate including transaction review, land use planning, licensing, mediation, arbitration and court matters throughout Oregon and Washington.

What if the buyer doesn't qualify? - Alternatives to Conventional Financing

The current real estate market has brought about many interesting, but not entirely new, scenarios. Although the market may currently favor buyers, conventional financing may be more difficult to obtain than in the past. As a result of the changing economy, the "mortgage crisis," and an increase in the number of foreclosures, many lenders have tightened their lending policies. Many brokers may experience this tightening the hard way – when buyers don't qualify for conventional financing on the properties they wish to purchase.

This article will address ways in which buyers and sellers can still close a deal despite a buyer's inability to qualify for conventional financing. In addition, it will outline a broker's role in facilitating such alternatives to conventional financing, and how a broker can ensure that he or she will still earn a commission on a deal.

In a situation in which a buyer learns he or she does not qualify for conventional financing for a home, the buyer and seller often part ways and the listing broker continues to list the property on behalf of the seller. However, savvy brokers may try to keep the deal together by encouraging the parties to explore alternative means of closing the deal. For instance, perhaps the seller is in a position to sell the home to the buyer on contract. The parties may not have considered alternatives to conventional financing, and the seller may be amenable to working with the buyer to close the deal.

Seller Financing

One way in which a non-qualifying buyer may be able to purchase a home is through seller financing. A seller may opt to finance a buyer's purchase for many reasons. For instance, perhaps the buyer is financially secure, but does not have a job history of sufficient length to qualify for conventional financing. Perhaps the seller is desperate to sell the home, and is willing to finance the buyer's purchase. Regardless of reason, seller financing can be a desirable option for many, particularly given that the seller may have adequate remedies available in the event the buyer defaults on the seller financing.

The parties may document a seller's financing of a buyer's purchase either through a trust deed, mortgage, or through a contract of sale. These financing options differ in a number of respects, including the rights and remedies available to the parties in the event of a default. For instance, a trust

deed or mortgage - calls for a transfer of the deed to the property. A contract of sale, however, does not call for a transfer of the deed until a future time, typically once the buyer has paid off the entire contract balance. For this and other reasons, a contract of sale may give the seller greater control over the property throughout the duration of the contract, and will entitle the seller to seek the buyer's forfeiture of the property in the event of a default. Any of these options will entitle a seller to foreclose on the property in addition to seeking other remedies.

A broker should strongly urge the client to obtain professional legal, investment, and/or tax advice prior to entering into any seller-financing arrangements, as there are a number of issues to consider when determining whether to offer, or accept, seller-financing. For example, the seller should review the terms of any underlying loan(s) on the property in order to determine whether there is a "due on sale" clause. Many lenders will require a property owner to obtain consent in order to transfer any interest in the property to a third party. Otherwise, the lender may reserve the right to call the entire loan due, thereby requiring the seller to either seek another source of financing to pay off the lender, or pay the remaining loan balance off with available cash. In some instances, a seller may opt to finance a buyer's purchase without seeking lender, running the risk that the lender could find out that the seller transferred his or her interest in the property, and require the seller to pay off the loan in full.

A seller should also consider whether to allow the buyer to transfer its rights in the property during the duration of the seller's financing. A seller may not want the buyer to have the ability to transfer any interest in the property, to ensure that the buyer is still on the hook for the entire obligation. In addition, a buyer's transfer of an interest in the property could result in additional risk to the seller, as the new occupant or owner of the property may not take care of the property, or be financially responsible.

As well, a seller should determine whether to allow the buyer to borrow additional funds on the property from third parties, and if so, whether the seller will subordinate its interest to that of an outside lender. Such subordination will undoubtedly reduce seller's control over the property and its secured position, in that the buyer may borrow more than the value of the property, including a new loan in combination with the seller's existing loan. Additionally, the buyer may potentially borrow on unfavorable terms (*i.e.* balloon payments and pre-payment penalties), or may default on the financing. As well, the buyer may have less motivation to satisfy its obligations with respect to the property if the buyer does not have a significant financial investment in it.

Lease Options

Another way in which a non-qualifying buyer may be able to purchase a home is through a lease option. Although a lease option grants a buyer rights that are initially different from a regular purchase, the buyer will have the ability to occupy the property, and purchase the property at a later time. This arrangement allows the parties to keep a deal together until the buyer can qualify for financing.

There are many issues that sellers should consider with regard to lease options. For instance, is lender consent required before the seller can enter into the lease option? The seller's loan terms may include a "due on sale" clause, and some lenders may consider a lease option a transfer of interest in the property. Brokers should advise sellers considering lease options that they should verify that their loan terms do not prohibit such a transaction.

Sellers may also want to consider how to protect themselves during the term of the lease and option period. Many buyers and sellers erroneously assume that a lease option buyer must maintain the property. However, landlord/tenant laws apply to a lease option, and the seller will be responsible for

complying with such laws. As a result, sellers should seek careful drafting of each party's responsibilities within the lease option so as not to violate landlord/tenant laws. Sellers may protect themselves in other ways, notwithstanding landlord/tenant laws. For instance, a seller may require the purchase price for the property to be increased by any uninsured damage to the property, certain significant repairs, or property taxes paid by the seller on the property. A seller may also want to require the buyer to pay all property taxes on the property, and maintain a minimum amount of insurance coverage on the property.

As with anything outside of the scope of a real estate licensee's work, buyers and sellers should be advised to seek professional legal, investment, and/or tax advice when considering a trust deed, mortgage, contract of sale, or lease option.

Commissions

Alternative financing arrangements can allow brokers to earn commissions on deals that would have otherwise not materialized. As with any standard transaction, brokers should consider how and when commissions will be paid on transactions involving seller financing or lease options. As transactions involving seller financing close in a similar way to those involving conventional financing, a broker could be paid a commission through closing.

However, a broker's commission for a lease option may be negotiated structured to provide one commission for negotiating the lease and a separate commission in the event the option is exercised. First and foremost, a listing broker should discuss with the seller at the time of the listing what commission will be paid in the event the seller decides to enter into a lease option agreement. For example, the seller and listing broker may agree to a commission of a percentage of the gross rents, in addition to a commission that will accrue if the option is exercised. The listing broker should state in both the RMLS® data and in an addendum to the listing agreement the method by which the commission will be split in the event of a lease option, in addition to the commission which applies when the option is exercised.

Conclusion

The good news is that a broker may be successful in keeping a deal together despite a buyer's inability to qualify for conventional financing. Although brokers may suggest that their clients consider seller financing or lease options, they should ensure that they don't further involve themselves in providing advice or in preparing trust deeds, mortgages, contracts of sale, or lease options. Once their clients decide to consider seller financing or a lease option, brokers should advise them to seek professional assistance in making the decision, and in drafting documents and determining the various tax and legal implications that may be involved with such arrangements.

This column contains general information only and must not be construed as legal advice. Questions may be submitted directly to Maylie & Grayson by fax at (503) 775-1765, by email at joelgrayson@mayliegrayson.com or by mail at 7959 SE Foster Road, Portland, Oregon 97206.