CONTRACTS FOR DEED AND WRAPAROUND MORTGAGES: NAVIGATING HIGH-RISK FINANCING

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REAL ESTATE LAW 101
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CHAPTER 7

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Cassie works to distill the complex legal issues to ensure the best possible resolution for her clients. She understands that many of these issues are emotionally-charged and works with her clients to make the best business decision.

Cassie represents companies and individuals in a wide variety of commercial disputes. Her current practice is focused on real estate, including title curative work, commercial property, landlord-tenant disputes, development issues, purchase and sale agreements, and breach of contract and business tort actions. Additionally, Cassie assists businesses in creating, implementing, and enforcing technology practices to protect confidential information and establish standards for use and access of company data.

Cassie's experience with real estate enables her to effectively handle probate and fiduciary litigation. Cassie works to uphold the wishes of those with established estate plans and defends fiduciaries wrongly accused of mishandling estates. Additionally, she helps beneficiaries who have been damaged by mismanagement by fiduciaries.

Cassie is actively involved with the Houston Bar Association and is the former chair of the Houston Bar Association Real Estate Section which provides continuing education and networking opportunities to the city's real estate attorneys. She also serves on the Houston Bar Association's Law Week Fun Run Committee, which produces the John J. Eikenberg Law Week Fun Run benefiting The Center for Pursuit (and served as a co-chair of this committee from 2016-2018). Additionally, Cassie serves on the board of directors for Houston Volunteer Lawyers and on the governing board for Trinity Lutheran Church Downtown. Cassie is a member of Leadership Houston Class XXXIV.

In her spare time, Cassie enjoys running, biking, and swimming. She has run more than ten marathons, three Iron Man triathlons, and numerous half-marathons, half-Iron Man triathlons, and sprint distance triathlons. She is currently focusing on running a Boston-qualifying marathon time.

LICENSES

- State Bar of Texas, 2006
- Southern District of Texas, 2008
- Eastern District of Texas, 2014

PRACTICE AREAS

Real Estate Law
Title
Business Law
Probate Litigation

SERVICES

Real Estate Litigation

- Title and Boundary Disputes
- Fraud and Forgery
- Lease Disputes
- Joint Tenant Disputes
- Quiet title actions
- Property Owner Association Disputes

Real Estate Transactions

- Due Diligence, Acquisition and Sale
- Multifamily, Retail, Office and Industrial Development and Leasing

Commercial Lending Transactions

- Closing Real Estate and Collateral Equipment Loans
- Negotiation and Drafting of Commercial Loan Documents
- Reviewing Surveys, Title Insurance, and Exceptions

Corporate and Business Law

- Entity Formation, Dissolution, and Corporate Governance
- Contract Negotiation, Drafting, Review and Disputes,
- Outside General Counsel

Probate and Fiduciary Litigation

- Will Disputes
- Guardianship Disputes
- Undue Influence / incapacity issues
- Beneficiary Disputes
- Breach of Fiduciary Duty
- Executor Misconduct

ACTIVITIES and HONORS

- Double Board Certified by the Texas Board of Legal Specialization – Commercial and Residential Real Estate
- Houston Bar Association President's Award 2016 and 2017
- Leadership Houston Class XXXIV
- Texas Rising Star — 2014, 2015, 2016, 2017, 2018, 2019, and 2020
- Houston Bar Association Law Week Fun Run Committee
    - Committee Co-Chair 2016-2017
    - Publicity Sub-Committee Chair 2015-2016

  - Committee Member 2013-2015
  - Counsel: 2015-2016, 2016-2017
- Houston Bar Association Real Estate Section
  - Immediate Past-Chair 2019-2020
  - Chair 2018-2019
  - Chair-Elect 2017-2018
  - Counsel 2015-2016, 2016-2017
- Houston Volunteer Lawyers Program – frequently accept pro bono cases through HVLP and volunteer with legal clinics
- Houston Volunteer Lawyers Program Award for Outstanding Pro Bono Achievement 2019
- Friendswood Rotary Club
- Avid runner and triathlete. Completed more than 12 marathons and numerous triathlons, including three Ironman triathlons

EDUCATION

University of Houston Law Center, Houston, Texas
Doctorate of Jurisprudence

Activities and Honors
- Houston Journal of International Law, Lecture Series Editor
- Dean's Merit Scholarship
- Student Research Assistant, Professor Robert Ragazzo

University of St. Thomas, Houston, Texas
Bachelor of Arts in Political Science; Minors: Philosophy and English
Honors Program Graduate; Magna Cum Laude Graduate

Activities and Honors
- Honors Thesis – Internet Voting: The Next Step in E-Democracy?
- Aquinas Honor Society
- Election Commission Chairperson

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INTRODUCTION

Contracts for deed and wraparound mortgages are two dubious forms of residential seller-financing that, from the outset, this article and its author warns against. Unfortunately, it is not uncommon in residential transactions for the parties to explore these types of financing and, when they are completed without counsel, they frequently go awry. This article will acquaint you with the tedious requirements imposed upon these transactions and how to navigate the common pitfalls that the buyers/sellers encounter.

In an executory contract (or a "contract for deed"), a purchaser obtains an immediate right to possession while the seller retains legal title. (This type of transaction is also referred to as "rent-to-own"). The seller has no obligation to transfer title to the purchaser until the purchase price is paid in full. Similarly, the purchaser may not have an obligation to complete the purchase of the property.

In a wraparound mortgage (or a "wrap mortgage"), the seller loans the purchaser the money to buy the property. What distinguishes a wrap mortgage from ordinary seller-financing is that in a wrap mortgage, there are two lenders− the seller and the original issuer of the mortgage. While the seller maintains an outstanding debt to its lender, he also becomes a lender to the purchaser who buys the property on loan from the seller. In theory, the purchaser pays the seller, and the seller pays off his original mortgage.

Wraparound mortgages and contracts for deed are often adopted as last resort financing by people who cannot obtain conventional financing. The purchasers are stereotypically either low-income or have unverifiable income and, as such, are not able to satisfy the underwriting requirements for conventional lenders. As there is a perceived disparity in negotiating position between the purchasers and sellers in these transactions, the Texas Legislature has set forth substantial statutory requirements for wrap mortgages and contracts for deed. These requirements are typically designed to protect the buyers and impose strict penalties on the sellers for failure to comply.

Unfortunately, many parties orchestrating these transactions are not aware of the significant statutory hurdles and/or requirements imposed by the Legislature. Even when the provisions of the statutes have been met, these transactions can result in significant loss for the parties. For example, in a contract for deed, a purchaser who has paid 39.9% of the loan and defaults on a payment may not solely lose their home, but they also lose all the equity that has built up in the home.

This paper sets forth the statutory requirements prescribed by the Texas Legislature, describes the common issues, and provides recommendations for when you have a client involved in one of these transactions. The main recommendation being −don't do it!

CONTRACT FOR DEED

What is a Contract for Deed?

A contract for deed, or an executory contract, is a transaction where the purchaser has immediate possessory rights in the property, but the seller retains the ownership rights until the purchaser furnishes the full purchase price of the property. Typically, the purchaser pays in installments, and after making the final payment, the purchaser owns the property.[1]

Why is Entering into a Contract for Deed a Bad Idea?

As illustrated through this article's discussion of the law, contracts for deed have robust statutory requirements that may be nearly impossible for the seller to satisfy. These contracts typically fail both the expectations of the buyer and the seller. A client who is a seller may come to you having not seen a payment from the purchaser in months. And conversely, a client who is a buyer may ask why they are now being called a tenant after missing a payment or two or why they are being evicted from their home.

Because these arrangements are often entered into by purchasers who are low income and lack the ability to enter into a traditional purchase money mortgage, these arrangements often have a large detrimental impact and are not properly vetted. However, the law purposefully places rigorous requirements on the seller to deter sellers from entering these contracts in the first place.

For instance, if a seller fails to comply with the requirements imposed by law, they may be required to pay significantly in damages, which in some instances includes treble damages under the Texas Deceptive Trade Practices & Consumer Protection Act. Violations of certain sections can also result in the entitlement of the purchaser to cancel or rescind the contract and receive a full refund of all payments made to the seller albeit offset by the purchaser's duty to restore to the seller the value of purchaser's occupation of the home

1 *See e.g.*, *Bryant v. Cady*, 445 S.W.3d 815, 822-23(Tex.App.—Texarkana 2014, no pet.)(explaining that under a contract for deed the buyer has the right but no obligation to complete the purchase; unlike in a typical real estate contract).

for that period. *Morton v. Nguyen*, 412 S.W.3d 506, 512 (Tex.2013).

Typically, the author advises clients not to use contracts for deed or to draft around the statute. However, as discussed, you may have a client who did not receive this advice and now has a contract for deed that has gone awry. For these situations, it is important that you consult the statutory requirements fully when advising your client.

Statutory Requirements

The law governing contracts for deed is set forth in Texas Property Code §§ 5.061− 5.087.[2] As previously mentioned, the statutory requirements for contracts for deed are substantial. All requirements must be satisfied at the time of creation for the contract for deed to succeed. This article will address the rules provided under Chapter 5 of the Texas Property Code relating to contracts for deed. However, if you are drafting a contract for deed for a client, please use the statutes themselves to evaluate your satisfaction of the requirements.

Although this article will organize the statutory requirements in a digestible format, in practice, it is imperative that you carefully assess each statute in determination of compliance. It is equally important to review the statutes when a client comes to you with a pre-existing agreement. In the latter case, the potential non-compliance with the statutory requirements may lead to a quicker settlement or an argument in favor of your client.

When Do the Statutes Apply?

The statutes apply only to transactions involving conveyances of real property *used or to be used* as the purchaser's **residence**[3] or as the residence of a person related to the purchaser within the second degree of consanguinity.[4]

When Do the Statutes Not Apply?

The statutes do not apply to the sale of state land; the sale of land by the Veteran's Land Board; and the sale of land by the state or a political subdivision of this state, or an instrumentality, public corporation, or other entity created to act on behalf of this state, including an entity created under Chapter 303, 392, or 394, Local Government Code.[5] Furthermore, the statutes do not apply to a contract for deed that provides for the delivery of a deed from the seller to the purchaser within 180 days of the date of the final execution regardless.[6]

There are also situations where the statutes can be waived, or partial application is permissible. If the purchaser of the property is related to the seller within the second degree by consanguinity or affinity, she can waive the applicability of §5.066 and §§5.068−5.080.[7] And in an agreement involving an option to purchase real property that includes or is executed concurrently with a residential lease agreement, § 5.066, § 5.067, § 5.071, § 5.075, § 5.079, § 5.081, and § 5.082 do not apply.[8] In this latter scenario, if the term of the contract is three years or less and the parties or their agents, assignees, or affiliates have not been parties to a contract for deed for longer than three years, the only provisions that apply are §§ 5.063−5.065, § 5.073, except for § 5.073(a)(2); and § 5.083 and § 5.085.[9]

Residential Property Not Defined by the Statute

As noted above, the statute applies when the property involved is either *used or to be used* as the purchaser's residence[10] or as the residence of a person related to the purchaser within the second degree of consanguinity.[11] Unfortunately, this section of the Property Code does not define the term "residence", nor does it provide a specific timeline for the property to become the residence. In the absence of a statutory definition, Texas courts have adopted the Texas Supreme Court's definition of "residence." When interpreting a statute without a definition for residence, the Court defined a residence as a "'[p]lace where one actually lives or has his home; a person's dwelling place or place of habitation; [or]. . . a dwelling house.'"[12] Courts interpreting residence as used in Chapter 5 Subchapter D of the Texas Property Code have also adopted this definition.[13] These courts have noted that an individual does not have to be physically present within the home in order to claim it as her residence.[14] Furthermore, an individual may live in one

3 The law provides that a lot measuring one acre or less is presumed to be residential property. Tex. Prop. Code § 5.062(a)(1).
4 Tex. Prop. Code § 5.062(a).
5 Tex. Prop. Code § 5.062(b)(1)-(2).
6 Tex. Prop. Code § 5.062(c).
7 Tex. Prop. Code § 5.061(d)(1)-(2).
8 Tex. Prop. Code § 5.061(e).
9 Tex. Prop. Code § 5.061(f)(1)-(3).

10 The law provides that a lot measuring one acre or less is presumed to be residential property. Tex. Prop. Code § 5.062(a)(1).
11 Tex. Prop. Code § 5.062(a).
12 *Owens Corning v. Carter*, 997 S.W.2d 560, 571 (Tex. 1999)(quoting BLACK'S LAW DICTIONARY 907 (abridged 6th ed. 1991))(interpreting the term "residence" in the absence of a definition in the forum non conveniens statute)
13 *Dickey v. McComb Dev. Co.*, 115 S.W.3d 42, 45 (Tex. App.—San Antonio 2003, no pet.)
14 *Id.*

place temporarily while having a residence in another.[15] Even if the individual leases her residence while physically absent from it, she may still be able to claim the property as her residence.[16] The language "used or to be used" is also broad and has been construed by courts to apply to the real property the purchaser is presently using as her residence or the real property which she will use as her residence in the future.[17]

To execute a contract for deed, the seller must have fee simple in the property, free from any liens or encumbrances.[18] This means that even if the property is an empty lot, if the purchaser intends to use the lot as residential property, and the seller has a fee simple in the property, the statutes apply. Furthermore, if this residential property is for the purchaser's granddaughter, the statutes will apply.

Additionally, an option to purchase real property that is included in or with a residential lease agreement is considered a contract for deed for the conveyance of real property.[19] However, these rules do not apply to a contract for deed that provides for the delivery of a deed from the seller to the purchaser within 180 days of the date of the final execution of the contract for deed[20] or to oral agreements.[21]

Seller Specific Requirements

Pursuant to the provisions of Chapter 5 Subchapter D of the Texas Property Code that apply to contracts for deed, the seller is obligated to provide the buyer with several documents prior to or at the time of execution of the contract. The Legislature created these burdensome statutory requirements to dissuade sellers from entering into contracts for deed. Below is a list of what the seller must provide the buyer with references to the corresponding statutes[22] :

- *Property Condition.* A seller must provide the buyer a written disclosure of the property's condition prior to the execution of the contract in the statutory form prescribed by the statute.[23]
- *Survey.* Prior to the execution of the contract, the seller must deliver to the buyer a survey completed within the year prior to executing the contract or a plat of a survey current as of the time of the execution of the contract.[24]
- *Encumbrances or Other Claims.* Prior to the execution of the contract, the seller must provide the buyer with a legible copy of any documents describing encumbrances or other claims, including a restrictive covenant or easement, that affect title to the property.[25]
- *Tax Payments and Insurance Coverage.* A seller must deliver a written disclosure of tax payments and insurance coverage to the buyer prior to the execution of the contract in accordance with the statute, including the tax certificates from the collector on each taxing unit that collects taxes due on the property as provided by Section 31.08 of the Tax Code; as well as a legible copy of an insurance policy relating to the property.[26]
- *Financing Terms.* A seller must provide a written statement disclosing the financing terms of the contract, which includes: (1) the purchase price of the property; (2) the interest rate charged under the contract; (3) the dollar amount of the interest charged for the term of the contract; (4) the total amount of principal and interest to be paid under the contract; (5) the late charge, if any, that may be assessed under the contract; and (6) the fact that the seller may not charge a prepayment penalty or any similar fee if the purchaser elects to pay the entire amount due under the contract before the scheduled payment date under the contract. This disclosure is to be delivered to the buyer prior to the execution of the contract in accordance with the statute.[27]
- *Prohibition on Oral Agreements.* A seller must provide buyer with a written notice that oral agreements are prohibited in 14-point uppercase typewritten letters. This notice is required to be delivered by the seller to the buyer prior to their

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15 *Id.*
16 *Id.*
17 *Marker v. Garcia*, 185 S.W.3d 21, 25-26(Tex.App—San Antonio 2005, no pet.)(citing *Sanchez v. Brandt*, 567 S.W.2d 254, 258(Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.).
18 There are some exceptions to this general rule, including a purchase money mortgage. However, a violation of the requirements under Section 5.085 of the Texas Property Code will be considered a false, misleading, or deceptive act under the Texas Deceptive Trade Practices & Consumer Protection Act. The consequences for the seller include returning all payments of any kind made to the seller under the contract, reimbursement for any payments the purchaser made in tax on the property, reimbursement of the value of any improvements made to the property by the purchaser, treble damages, and attorney's fees. Tex. Prop. Code § 5.085.
19 Tex. Prop. Code § 5.062(a)(2).
20 Tex. Prop. Code § 5.062(c).
21 Tex. Prop. Code § 5.072.
22 Again, in practice, please consult each statute accordingly. For some of these seller-specific rules, the law requires specific language, font, or forms, and it is imperative that you use the statute itself to assess your compliance.
23 Tex. Prop. Code § 5.069(a)(3).
24 Tex. Prop. Code § 5.069(a)(1).
25 Tex. Prop. Code § 5.069(a)(2).
26 Tex. Prop. Code § 5.070.
27 Tex. Prop. Code § 5.071.

execution of the contract in the statutory form prescribed by the statute.[28]

- *Purchaser's Right to Cancel Contract*. A seller must provide the buyer with a written notice of purchaser's right to cancel the contract without cause in 14-point uppercase typewritten letters. This notice is required to be included by the seller in immediate proximity to the signature space for the buyer on the contract at execution of the contract in the statutory form prescribed by the statute.[29]
- *Notice of Cancellation*. At the time of execution of the contract, the seller must provide the buyer with written notice of cancellation in 14-point uppercase typewritten letters in the statutory form prescribed by the statute.[30]
- *Recording Evidence*. The seller is required to record the contract, including the attached disclosure statement required under Section 5.069, in the county real property records within 30 days after its execution. If the contract is terminated for any reason, the seller shall record the instrument that terminates the contract.[31]
- *Equitable Interest*. Before entering a contract for deed, a seller must disclose to any potential purchaser that the seller is selling only an option in a contract and that the purchaser does not have legal title to the real property.[32]
- *Annual Accounting Statements*. The seller shall deliver to the buyer an annual accounting statement by January 31st. [33]

The failure to comply with these requirements violates the relevant Texas law provisions referenced herein and many of them include liability for treble damages and attorneys' fees under the Texas Deceptive Trade Practices & Consumer Protection Act.

Transfer of the Deed

Upon final payment, the title should be transferred to the purchaser under the implied general warranty set forth by the statute.[34] If the contract for deed has not been recorded, the seller shall transfer recorded legal title of the property covered by the contract for deed to the purchaser not later than the 30th day after the date the seller receives the purchaser's final payment due under the contract.[35]

If the seller fails to transfer the title, the seller is liable to the purchaser for liquidated damages in the amount of $250 a day for each day the seller fails to transfer the title to the purchaser during the period that begins the 31st day and ends the 90th day after the date the seller receives the purchaser's final payment.[36] Additionally, the seller must pay $500 a day for each day the seller fails to transfer title to the purchaser after the 90th day after the date the seller receives the purchaser's final payment.[37] The seller is also liable to the buyer for any reasonable attorney's fees.[38]

Default

After buyer's default, the seller can rescind the contract but is subject to several restrictions imposed by the Legislature. Under Section 5.064 of the Texas Property Code, a seller may enforce the remedy of rescission or of forfeiture and acceleration against a purchaser. However, the seller can enforce the remedy only if: (1) the seller notifies the purchaser of the seller's intent to enforce a remedy in the form provided by the statute;[39] (2) the seller notifies the purchaser of the purchaser's right to cure the default within the 30-day period described by Section 5.065[40]; (3) the purchaser fails to cure the default; (4) Section 5.066 does not apply;[41] and (5) the contract has not been recorded in the county in which the property is located.

Notice

Under Section 5.064 of the Texas Property Code, notice must be in writing and must be delivered by registered or certified mail, return receipt requested, to the purchaser's residence or principal place of business. The statute requires that notice be conspicuous and printing in 14-point boldface type or 14-point uppercase typewritten letters, and must include on a separate page the statement:

NOTICE

> YOU ARE NOT COMPLYING WITH THE TERMS OF THE CONTRACT TO BUY YOUR PROPERTY. UNLESS YOU TAKE THE ACTION SPECIFIED IN THIS NOTICE BY (date) THE SELLER HAS THE RIGHT TO TAKE POSSESSION OF YOUR PROPERTY.

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28 Tex. Prop. Code § 5.072(d).
29 Tex. Prop. Code § 5.074(c).
30 Tex. Prop. Code § 5.074(d).
31 Tex. Prop. Code § 5.076(a).
32 Tex. Prop. Code § 5.086.
33 Tex. Prop. Code § 5.077.
34 Tex. Prop. Code § 5.079(a).
35 *Id.*
36 Tex. Prop. Code § 5.079(b)(1)(A).
37 Tex. Prop. Code § 5.079(b)(1)(B).
38 Tex. Prop. Code § 5.079(b)(2).
39 The requirements for notice are substantial. Tex. Prop. Code § 5.063.
40 Tex. Prop. Code § 5.064.

Notice must also: (1) identify and explain the remedy the seller intends to enforce; (2) if the purchaser has failed to make a timely payment, she must specify: the delinquent amount (itemized to principal and interest), any additional charges claimed, such as late charges or attorney's fees, and the period to which the delinquency and additional charges relate; and (3) if the purchaser has failed to comply with a term of the contract, identify the term violated and the action required to cure the violation.

Buyer's Equity in the Property

If the buyer defaults, the buyer usually loses all "equity" in the property. In the case of default, the buyer's prior payments are viewed as rent and not equity, and therefore, buyer is not entitled to the potential reimbursement of those payments. However, there is an exception to this rule.

Under Section 5.066 of the Texas Property Code, if the buyer has paid 40% of the purchase price or has made 48 payments, then the seller must foreclose or accelerate. The law requires the seller to notify[42] a purchaser of a default under the contact and allow the purchaser 60 days after the date of notice to cure the default as opposed to the ordinary rule of 30 days.[43] After the period to cure has past, a trustee designated by the seller must post, file, and serve a notice of sale.[44] At the sale, the remaining balance of the amount due under the contract is the debt.[45] If the proceeds of the sale exceed the debt amount, the seller shall provide the excess funds to the purchaser under the contract.[46] If the sale amount is less than the debt owed, then the seller's right to recover the deficiency is subject to Section 51.003, 51.004, and 51.005 unless a provision releases the purchaser under the contract from liability.[47]

Some Recommended Strategies

(1) Provide a Valid Legal Description

When drafting a contract for deed, it is imperative that you consult the statutory language set forth under Chapter 5 Subchapter D of the Texas Property Code. However, one must also remember that the contract must comply with the Statute of Frauds. One of the most common mistakes in a contract for deed is the failure to provide a valid legal description of the property. The legal description of the property must be included in the contract, or it is in violation of the Statute of Frauds, and the contract will be unenforceable. An address is typically insufficient to legally describe the property. A valid legal description may depend on the type of land in question, but a common valid legal description provides the lot and block information of the property.

(2) Convert the Contract

Because of the dubious nature of contract for deed, it may be in the interests of both the seller and purchaser to convert the contract. Conversion will protect the seller from the punitive measures under the statutes, and it will protect the purchaser from the loss of equity in their home.

A purchaser under a contract for deed is entitled to convert the purchaser's interest under a contract for deed into recorded, legal title by tendering (1) the full amount due or (2) a promissory note that is equal to the balance owed to the seller and that contains the same interest rates, due dates, and late fees as the contract.[48] Once the seller has received the payment in full or the promissory note, the seller must execute a deed conveying recorded, legal title to the property.[49]

In delivering a promissory note, the purchaser must also execute a deed of trust that contains the same terms as the contract regarding the purchaser's and seller's duties concerning the property and secures the purchaser's payment and performance under the promissory note and deed of trust.[50] This deed of trust must also convey the property to the trustee, in trust, and confer on the trustee the power to sell the property if the purchaser defaults on the promissory note or the terms of the deed of trust.[51] The seller has 10 days to either deliver to the purchaser a written explanation that legally justifies why the seller refuses to convert the purchaser's interest into recorded, legal title or schedule a mutually agreeable day and time to execute the deed and deed of trust with the purchaser.[52]

Before the contract is converted, a purchaser should request a balance and a trustee. Under Section

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[42] It is worth mentioning that in these cases the notice required by law is different. Under Section 5.066 of the Texas Property Code, the notice must be provided as prescribed by Section 5.063, except that the notice must substitute the following statement:

NOTICE
YOU ARE NOT COMPLYING WITH THE TERMS OF THE CONTRACT TO BUY YOUR PROPERTY. UNLESS YOU TAKE THE ACTION SPECIFIED IN THIS NOTICE BY (date) A TRUSTEE DESIGNATED BY THE SELLER HAS THE RIGHT TO SELL YOUR PROPERTY AT A PUBLIC AUCTION.

Tex. Prop. Code § 5.066(b).

[43] *Id.*

[44] Tex. Prop. Code § 5.066(c).

[45] Tex. Prop. Code § 5.066(e).

[46] *Id.*

[47] *Id.*

[48] Tex. Prop. Code § 5.081(b)-(c).

[49] Tex. Prop. Code § 5.081(c)(1).

[50] Tex. Prop. Code § 5.081(c)(2)(A)-(B).

[51] Tex. Prop. Code § 5.081(c)(2)(C).

[52] Tex. Prop. Code § 5.081(d)(1)-(2).

5.082(a) of the Texas Property Code, a seller, upon request, must provide a purchaser with (1) the amount owed by the purchaser under the contract and (2) the name and address of the seller's desire trustee for a deed of trust to be executed in the event of conversion.[53] The balance will establish the fundamental question of amount owed and aid the parties in determining their most feasible options. This is an important jumping off point before diving into the process of converting the contract.

If the seller fails to provide a timely response to the request for balance and trustee, the purchaser may determine or pay the amount owed under the contract. This includes determining the amount necessary for a promissory note and selecting a trustee for the deed of trust. The purchase must send seller notice of the amount determined, and the seller has twenty days to object.

Another important consideration is whether the seller owes the purchaser for violations under the statutes. If the seller has violated the requirements of Chapter 5 of the Texas Property Code and owes the purchaser damages, the law allows the purchaser to deduct that amount owed by the seller from the amount due under the contract.[54] Most importantly, the purchaser can do this without judicial action.[55]

(3) Draft Around the Statute

If the statute does apply, consider drafting the contract so that it falls outside of the statute. Specifically, draft the contract so that title must vest within 180 days.

Another potential option is to recharacterize the purchase as a business transaction. While the author does not endorse this method, one could potentially draft around the statute by recharacterizing the transaction as the purchase/acquisition of a limited liability company (LLC). More particularly, the transaction could be structured such that seller and buyer are the sole members of an LLC that owns the property at issue. The membership agreement may provide that buyer has the exclusive right to use the property and may provide a schedule for the buyer to acquire additional membership interests in the LLC from the seller. As such, as the buyer acquires additional membership interests in the LLC, eventually the buyer will become the sole member of the LLC – and, as such, the sole owner of the property. At that point, the LLC may be dissolved, and the assets (the property) distributed to the member.

(4) Consider the Parties and the Property at Issue.

The author recommends against contracts for deed because of the onerous provisions imposed against the sellers. Nevertheless, clients always present unique circumstances and there may (while unlikely) be a situation where a contract for deed is preferred to a typical warranty deed, deed of trust, and promissory note. In these situations, you should consider the sophistication and/or the relationship between the parties; the length of the payment term; and the type/use of the property at issue. Based on these elements, there could be a situation where a contract for deed would be beneficial. That said, the only time I would personally consider a contract for deed would be if the transaction fell outside the scope of the statute (i.e, was for related parties or was for non-residential/investment property).

WRAPAROUND MORTGAGE

A wraparound mortgage is a type of seller financing. As the name suggests, wraparound mortgages involve a mortgage that wraps around an existing mortgage, functioning as a type of junior lien.[56] The seller maintains his existing mortgage and assumes the role of lender by loaning the buyer the funds to purchase the property, creating a second mortgage. In this arrangement, even if the buyer does not miss a payment on the wraparound mortgage, if the seller fails to maintain its mortgage, the original lender can still foreclose on the property.

From the outset, it is critical to make sure you have the proper documentation when entering a wraparound mortgage. A properly drafted wraparound mortgage will include at least four documents: (1) a warranty deed with a vendor's lien conveying title to the buyer subject to the wrapped note; (2) a wraparound deed of trust securing payment of the wraparound note; (3) a wrap note signed by the buyer; (4) a wraparound agreement to address the details; (5) disclosure notices required by Section 159.101 of the Texas Finance Code. Additionally, a down-payment note may be included if applicable.

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[53] Tex. Prop. Code § 5.082(a).

[54] Tex. Prop. Code § 5.084.

[55] *Id.*

[56] Under Section 159.001(7) of the Texas Finance Code, a wraparound mortgage loan is "a residential mortgage loan made to finance the purchase of residential real estate that will continue to be subject to an unreleased lien that attached to the residential real estate before the loan was made; and secures a debt incurred by a person other than the wrap borrower that was not paid off at the time the loan was made; and obligating the wrap borrower to the wrap lender for payment of a debt the principal amount of which includes the outstanding balance of the debt and any remaining amount of the purchase price financed by the wrap lender." Tex. Fin. Code § 159.001(7).

Wraparound Mortgage vs. Contract for Deed

Wraparound mortgages differ from contracts for deed in a few ways. Contracts for deed are executory contracts and are fulfilled or executed when the purchaser pays the purchase price, and the seller transfers the deed. In contrast, wraparound mortgages are executed at closing, which results in the immediate delivery of the deed. When a debtor defaults on a wrap mortgage, the seller cannot simply cancel or rescind the contract, while a seller in a contract for deed can. The seller in a wraparound mortgage must foreclose on the property to retrieve the title back from the purchaser. Furthermore, different laws apply to each seller-financing arrangement. As discussed, contracts for deed are governed by the Texas Property Code. Wrap mortgages, on the other hand, are governed primarily by the Texas Finance Code.

Why Parties Choose a Wraparound Mortgages

There are several reasons why parties may choose to pursue a wraparound mortgage over a traditional mortgage.

For the seller, a wraparound mortgage might be attractive because the seller may be able to sell for a higher price than what the market would offer. Often the seller will increase the interest rate slightly, in turn, making a profit on the difference between the interest rate on the wrapped note and the original. However, that higher rate may still be lower than the prevailing interest rate, especially in a period of rising interest rates, which appeals to wrap buyers. For example, on the original mortgage, the interest rate for sale might be 6 percent, but seller would demand a 7 percent interest rate from buyer. Additionally, a seller might want a wrap mortgage because the seller receives some portion of cash immediately in the form of a down payment. The seller has the option to pocket this money or use it to reduce the principal on his original loan.

For the buyer, a wrap mortgage could be his only option for home financing because he does not qualify for a traditional mortgage. Also, there might not be a market for people like the buyer to get credit. By entering into a wrap mortgage, the buyer, in some ways, benefits by avoiding the costs of closing and high loan fees while gaining title and immediate possession of the property. Additionally, the buyer is spared from the process of applying and qualifying for a new loan, which may result in considerable delays.

Why Parties Should NOT Choose Wraparound Mortgages

There are many reasons why wraparound mortgages are highly unadvisable. One of the first reasons why one should not choose a wraparound mortgage is that, once created, the wrapped loan is frozen in place and cannot be refinanced for the duration of the wrap. Furthermore, the seller must wait until the wraparound mortgage has matured before they can get the full proceeds of the sale.

For the buyer, the seller could decide to stop making payments on their existing mortgage, which will likely result in the foreclosure of the buyer's home. On the other hand, if the buyer were to stop making payments, the seller retains the full responsibility of paying the mortgage. However, buyers can take preventative measures by making their payments directly to the original lender.

Keep in mind, that a wraparound mortgage may not be the answer if the original deed of trust contains a due-on-sale clause. A due-on-sale clause gives the original lender the right to demand payment upon conveyance of the property. Sometimes a due-on-sale clause demands acceleration. However, most residential due-on-sale clauses only give the lender the option to take action if it wishes. Meaning the lender can accelerate but is not required to accelerate. Lenders are not likely to foreclose on a preforming loan, even if transfer of ownership would allow it. However, as interest rates continue to soar higher, lenders may become more incentivized to push back on loans with low interest rates.

What is the new law?

Texas Senate HB 43, effective January 1, 2022, addressed three major concerns: (1) fraud involving financing when a residential property with an outstanding lien is sold without notifying the owner of the lien; (2) foreclosure by a lender on property without any form of missed payment to the lender; and (3) loans which may never have been recorded.[57] Additionally, the enacted bill added several provisions in order to protect purchasers under wraparound mortgages, which include:

- providing for wrap payments to be held in a constructive trust by the seller for the benefit of the buyer[58]
- establishing that anyone collecting payment from a wrap borrower in connection with a wrap mortgage

[57] For more information about HB 43, see Cassandra McGarvey, *Wrap-Around Mortgages*, MCGARVEY PLLC (July 29, 2021), https://www.mcgarveypllc.com/wrap-around-mortgages/.

[58] Tex. Fin. Code § 159.151.

owes a fiduciary duty to the borrower for the payments[59]

- requiring seller-disclosure of the nature and risks of wrap transactions to buyers and offering consumers the right to rescind the transaction when disclosures are not made timely[60]
- clarifications that a wrap mortgage loan may only be closed by an attorney or title company[61]
- prohibiting a person from making wrap mortgage loans unless the person is licensed or registered to originate or make residential mortgage loans[62]

Notice

The seller must also provide notice to the buyer that an unpaid lien exists on the property[63] and notice warning buyer of potential insurance coverage problems.[64] Both must occur within seven days of the wraparound mortgage being entered into and be written in 12-point type.

The notice of the existence of the unpaid lien requires that the seller: (1) identifies the property; (2) includes the name, address, and phone number of each lienholder; (3) states the amount of debt that is secured by each existing lien; (4) specifies the terms of any contract or law under which the existing loan to be wrapped is secured including the interest rate, the amount of monthly payments, and the account number; (5) states the amount of taxes that are due on the property; and (6) a statement at the top of the disclosure form substantially similar to this:[65]

> WARNING: ONE OR MORE RECORDED LIENS HAVE BEEN FILED THAT MAKE A CLAIM AGAINST THIS PROPERTY AS LISTED BELOW. IF A LIEN IS NOT RELEASED AND THE PROPERTY IS CONVEYED WITHOUT THE CONSENT OF THE LIENHOLDER, IT IS POSSIBLE THE LIENHOLDER COULD DEMAND FULL PAYMENT OF THE OUTSTANDING BALANCE OF THE LIEN IMMEDIATELY. YOU MAY WISH TO CONTACT EACH LIENHOLDER FOR FURTHER INFORMATION AND DISCUSS THIS MATTER WITH AN ATTORNEY.[66]

The second disclosure, concerning property insurance, must include a statement that is substantially similar to the following:

> ANY INSURANCE MAINTAINED BY A SELLER, LENDER, OR OTHER PERSON WHO IS NOT THE BUYER OF THIS PROPERTY MAY NOT PROVIDE COVERAGE TO THE BUYER IF THE BUYER SUFFERS A LOSS OR INCURS LIABILITY IN CONNECTION WITH THE PROPERTY. TO ENSURE THE BUYER 'S INTERESTS ARE PROTECTED, THE BUYER SHOULD PURCHASE THE BUYER'S OWN PROPERTY INSURANCE. BEFORE PURCHASING THIS PROPERTY, YOU MAY WISH TO CONSULT AN INSURANCE AGENT REGARDING THE INSURANCE COVERAGE AVAILABLE TO YOU AS A BUYER OF THE PROPERTY.[67]

Lastly, if the wrap is negotiated primarily in one language other than English, a wrap lender must provide to a wrap borrower a copy of the written disclosure statement in such language required by the statute.[68] The Department of Saving & Mortgage Lending has a Spanish language version of the disclosure form required on their website.[69]

Failure to Provide Notice

Under Section 159.104 of the Texas Finance Code, if a wrap mortgage agreement is closed without the seller providing the disclosure statements required, the buyer may rescind the agreement and any related purchase agreement at any time by providing the seller with notice of rescission in writing.[70] However, if the seller provides the notice after closing but before the buyer provides seller with notice of rescission, the buyer may rescind the wrap mortgage agreement and the related purchase agreement in writing on or before the 21st day after the buyer received seller's disclosure statement.[71] Once the buyer has rescinded, the seller has 30 days to return to the buyer (1) all principal and interest payments made by the buyer on the wrap mortgage; (2) any money or property given as earnest money, a down payment, or otherwise in connection with the loan; and (3) any escrow amounts for the loan.[72]

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59 Tex. Fin. Code § 159.152.
60 Tex. Fin. Code § 159.104.
61 Tex. Fin. Code § 159.105.
62 Tex. Fin. Code § 159.051.
63 Tex. Fin. Code § 159.101(a)(1).
64 Tex. Fin. Code § 159.101(a)(2).
65 Tex. Prop. Code § 5.016(a)(1)-(6).
66 Tex. Prop. Code § 5.016(a)(7).
67 Tex. Fin. Code § 159.101(a)(2).
68 Tex. Fin. Code § 159.102.
69 https://www.sml.texas.gov/forms/
70 Tex. Fin. Code § 159.104(a).
71 Tex. Fin. Code § 159.104(b).
72 Tex. Fin. Code § 159.104(c)(1)-(3).

Once the seller has returned to the buyer the money and property required under law, the buyer shall convey to the seller or seller's designee the residential real estate.[73] Furthermore, the buyer shall surrender the real estate within 30 days after the receipt of property owed.[74]

The law provides the seller an option to avoid rescission if he satisfies several requirements within the 30 days after he receives the buyer's notice of rescission.[75] However, to evade the buyer's rescission, the onus on seller is quite burdensome. To escape buyer's rescission, the law requires that the seller pay the outstanding balance due on its original mortgage, pay any due or unpaid taxes on the property, pay the buyer $1,000 and any reasonable attorney's fees incurred by the buyer, and provide the buyer with evidence that the seller has paid off the original mortgage and any outstanding taxes on the property.[76] Although the law provides an avenue for the seller to maintain his agreement with the buyer, the requirements are burdensome and unlikely to be satisfied. The statute favors parties who wish to get out of these agreements, especially when the seller has not complied with the statutes notice requirements.

Default

Even if a wraparound mortgage survives the statutory hurdles of notice, the wraparound mortgage still has a high risk of default. A wrap mortgage not only involves two or more loan agreements that are subject to default, but there are more people involved in the transactions, which creates more variability. For example, the buyer in a wraparound mortgage not only has to worry about making her own payments to avoid foreclosure, she also must worry about the seller making his own payments. Therefore, these agreements possess an inherently high risk of default and should be entered into with caution−if at all.

When a buyer defaults, the remedy is generally straight forward. If a buyer fails to make payment and defaults on the loan, the seller can foreclose. As in a typical foreclosure sale, the seller has the additional right to seek and obtain a deficiency judgement if the sales price at foreclosure is insufficient to discharge the wrap note including interest and fees.

However, when a seller defaults, the remedy is not as simple. If a seller defaults on his original loan, a typical wrap mortgage agreement allows the buyer to stop paying on the loan and to receive credit against the wrapped note. The buyer also has a right to deduct if the wrapped lien is not being timely paid by the seller.[77]

Texas Finance Code Exemptions

The laws governing wraparound mortgages specifically apply to investors in single-family homes, but it is important to keep in mind that there are a few exceptions to this general application. For example, these laws do not apply to a sale of residential real estate that is the wrap lender's homestead[78] or unimproved residential real estate if the holder of the unreleased lien has consented to the sale of the residential real estate.[79]

Furthermore, there is an exemption for any owner of residential real estate who in any twelve consecutive-month period makes no more than three residential mortgage loans to purchasers of property for all or part of the purchase price of the residential real estate against which the mortgage is secured.[80] Additionally, lenders who are federally-regulated lenders, non-profits, licensed mortgage brokers, and Section 503 (c)(3) organizations are also exempt from the rules as well as their employees.[81]

Avoid common pitfalls

Space out Payments. Be wary of timing on payments of both the notes. It is better to schedule the wrap around note payments a week or so in advance of when the original note is due. This gives the seller plenty of time to collect the payment from the buyer, then turn around and pay the lender.

Give Buyer Time. The longer the buyer has to find substitute financing, the more likely the wraparound mortgage is to be successful. Wraparound mortgages with a short balloon have a high likelihood of failing. Thus, a three-to-seven-year balloon is recommended.

Retain Casualty Insurance. As the seller, one might decide to cancel their casualty insurance policy considering there is a new owner: this is unwise. The wrapped lender will be notified of the cancellation, and the seller will typically receive a default letter from its lender who will "force place" another policy. This new policy is usually more expensive. Collection on insurance policy presents another issue for both the buyer and the seller. The buyer should obtain its own insurance policy because the old policy is unlikely to cover damages to a property which the policy holder no longer owns even if the seller asserts the claim on behalf of the buyer.

Obtain Title Insurance. The buyer should obtain title insurance if he is able to find it. Title companies may be averse to providing title insurance on a wrap mortgage.

Require the Appropriate Down Payment. In assessing the appropriate down payment, the seller

73 Tex. Fin. Code § 159.104(d).
74 *Id.*
75 Tex. Fin. Code § 159.104(e).
76 Tex. Fin. Code § 159.104(e)(1)-(4).
77 Tex. Fin. Code 159.202.

78 Tex. Fin. Code 159.002(b)(2).
79 Tex. Fin. Code 159.002(a)-(b).
80 Tex. Fin. Code 159.003.
81 *Id.*

should consider the borrower's credit, ability to repay, and risks of the transaction. By requiring the proper down payment, the seller provides himself some protection from the risks involved.

CONCLUSION

Contracts for deed and wrap mortgages are a potential minefield for a seller. And, even when they are prepared in accordance with the statute (or if the statute does not apply), they are risky transactions for the buyer and the seller. With each transaction, one must carefully check the requirements of the Property Code or the Finance Code, as applicable, to ensure that it was done correctly or confirm inapplicability to the transaction.