Executory Contracts in Texas

By Peter Squier

Rent-to-Own, Lease-Options and Contracts for Deeds are now regulated by the State of Texas. Most investors are unaware of the newer laws impacting these transactions. This article provides an overview of the laws.

Many landlords are asked by their tenants if they can buy the house they are renting, and many landlords want to sell their rental house and consider their tenants to be the best buyer. By selling to a known tenant, you can save on realtor fees, updating costs, and the loss of rent due to vacancy before selling. Known as "renting-to-own", "leasing-to-own", "lease-option agreements", and "contracts for deed", the practice of a tenant making payments and eventually owning the property has been going on for many years. Changes in Texas property law in 2005 and recent federal laws impacting the mortgage industry have changed the rules and made it much harder for landlords to offer such contracts.

Two separate legislative bills which took effect September 1, 2005 collectively make rent-to-own arrangements more difficult. Each bill was authored by Sen. Eddie Lucio (D-Brownsville) and sponsored by Rep. Harold Dutton (D-Houston). Senator Lucio, representing the Rio Grande Valley, is a champion of low income residents along the border, and Representative Dutton is a champion of low income residents around Houston. These two bills, Senate Bill 629 and House Bill HB 1823, were designed to protect low-income first-time home buyers from being taken advantage of by sellers offering rent-to-own agreements that posed undisclosed risk to the renter/buyers. However, these laws present significant challenges to well-intentioned landlords trying to help their tenant buy a home.

Executory Contracts

The new laws define rent-to-own, lease-options and contracts for deed with a duration longer than 6 months as "executory contracts". An executory contract is one in which the ownership of real property requires an action by one of the parties at some point in the future.

The law changes were initiated because previously sellers were able to retain legal title to their property while the buyers only had equitable rights that required an expensive lawsuit to enforce. Buyers who couldn't afford the lawsuit were left to abandon their rights and lose their down payments, option fees, or even portions of rent assigned to equity that they may have made. Unscrupulous sellers would evict buyers that hadn't completed their contract and keep whatever

Your tax office may offer delinquent tax installment plans that may be less costly to you. You can request information about the availability of these plans from the tax office.

monies they had accumulated. Several investors became notorious for preying on renters living in colonias (sub-standard housing for immigrants) along the border and inner city housing around Houston.

Mortgaged Properties

One of the biggest changes in the Texas laws is that now the seller must own the property free and clear in order to enter into an executory contract. Many landlords, trying to help a renter who didn't qualify for financing, offered to sell them the property subject to their mortgage. The landlord would take the buyer's payment and use it to pay the landlord's mortgage. This practice is what prompted the new laws because if the landlord doesn't pay their mortgage and the property is foreclosed upon, the buyer loses all of the equity they paid the landlord.

Not only must the seller own the property free and clear (no outstanding liens) in order to enter into an executory contract, but they must keep it that way for the entire contract period. The exception to this requirement (Section 5.085) is that it does not apply to a lien or encumbrance that is placed on the property before the sales contract as security for a loan used only to purchase the property if the seller, not later than the third day before the date the contract is executed, notifies the purchaser in a separate written disclosure of the name of the lender and the terms of the seller's underlying loan. In other words, if the owner bought the property with a mortgage and has no other liens on the property, he can still do a rent-to-own contract. However, the seller must provide a written disclosure to the buyer that specifies a) how much the seller paid, b) the remaining balance on the current mortgage note, c) the loan servicer, d) the mortgage due date, e) seller's monthly payment amount, f) the seller's mortgage loan number, g) servicer contact and phone number, and additional items that would normally never be disclosed to a prospective buyer and that may provide the seller with information that they can use to negotiate more favorable terms.

SB 629 also allows for the buyer and seller to agree that the seller may place an additional encumbrance on the property solely for the purposes of improving the property, but this requires the buyer's consent.

Requirements

Executory contract requirements go into effect at the time of the contract signature, not at the conclusion of the contract. The seller/landlord is now responsible for providing the following:

1. Financial disclosures, including:
   - o The price paid for the property
   - o The interest rate charged under the contract
   - o Total amount of principal and interest to be charged over term of contract
   - o The late fee that is applicable
   - o The condition that there is no prepayment penalty (this is not allowed)
2. A survey less than one year old or a current plat. The survey must show there are no restrictive covenants, easements or restrictions that prohibit building a house.
3. Copies of all relevant liens, restrictions and easements
4. A seller's disclosure of property condition
5. A tax certificate from each taxing unit collecting property taxes
6. Evidence and information on the property's insurance

Failure to provide all of the above is considered a violation of the Deceptive Trade Practices Act and is subject to fines and possible jail time, and the purchaser is able to rescind the contract and get back all monies paid including "rent".

Additionally, the seller must:

1. Provide the buyer and any lender seven days notice of the transaction in advance of the closing
2. Record the contract in the public records within thirty days of signing
3. Provide an annual accounting statement showing amount paid, remaining amount owed, etc.

Federal and State Requirements

Recent federal and state regulations for the financial industry created the S.A.F.E. Act which places a licensing requirement on certain types of owner financing, including executory contracts for the purchase of residential real estate. If you execute more than 5 executory contracts per year, you will need to be licensed as a residential mortgage loan originator with the Texas Department of Savings and Mortgage Lending and secure a Nationwide Mortgage Licensing System license.

The TDSML allows for the use of an "intermediary agent" who can complete such a transaction as a licensed third party. The agent will be responsible for providing all the federal and state paperwork required for a residential mortgage loan including the Good Faith Estimate, the Truth in Lending, getting an appraiser, etc. These agents usually charge a fee ranging from $500 to 1% of the transaction.

Another law passed from the mortgage crisis fallout was the Dodd-Frank Law known as the Mortgage Reform and Anti-Predatory Lending Act. The law places a burden on the loan originator to prove that the borrower can afford the loan payments - by collecting and providing a great deal of financial information, restricting interest rate terms, and more. The Dodd-Frank regulation kicks in if you do more than three seller financings per year.

Executory Contract Termination

When a renter stops making rent payments, it is relatively straightforward on how to evict him. But executory contracts complicate things for the landlord. A default requires a written notice after which the renter/buyer is allowed an unconditional 30 days to cure the default before an eviction can be filed. If the eviction is upheld in court, the seller may keep any buyer down payment.

Once the buyer has made 48 months of payments, or paid 40% or more of the purchase price, his rights change from renter to owner. Then, the seller must provide 60 days notice and undertake a foreclosure in order to regain the property.

Sellers may not impose any provision which increases the purchase price, imposes a fee or charge of any type, or otherwise penalizes a rent-to-own purchaser for requesting repairs or exercising any other right under Chapter 92 of the Texas Property Code.

Summary

A number of changes to the Texas Property Tax law and national mortgage laws greatly impact the use of rent-to-own, lease options and contract for deed transactions. These transactions are now much more difficult, and failure to abide by the laws can result in significant penalties. You should contact your real estate attorney for more information and assistance in creating your own executory contract.

About the Author: **Peter Squier is an Austin-based landlord, developer and real estate investor. He also serves as the President of Hunter-Kelsey of Texas LLC.**