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Options to the Dilemma of Owner Financing

It happens on a regular basis, someone asks me about doing owner financing on a property they own so they can sell it to a buyer who can't get a conventional mortgage. The logic is simple, it's better to take some income on the property than get nothing at all, and the selling price could be what the seller was asking. Sounds good, sell the property and put the money in a higher yielding mortgage instead of a certificate of deposit or a passbook account. But looks can be deceiving and reality can be cruel.

I remember one particular property in a neighborhood that I farmed extensively and which was in excellent condition. The homeowner would not take less than \$475,000 because he believed his property had an intrinsic value because Jack and President John Kennedy had actually slept in the home for three nights while President Kennedy was campaigning in my state – a long time ago. The homeowner was so enthralled with the event that he had a “historical” plaque made and mounted into a wall.

The value of the property at the time was about \$350,000 and I had offered \$300,000 because I had a buyers list of people who wanted to live in this specific subdivision. The seller was belligerent that he wouldn't take less than \$475,000 and that was that. Sometime later I noticed a moving van bringing a new couple and their family into the property. I looked in the public record, and sure enough, the seller had gotten \$475,000 for the property!

That's the good news; the bad news was that the buyer had gotten a conventional first mortgage for \$300,000 and a seller second for \$175,000. As might be expected, the real estate market was turning at that point and the buyer made about five payments on the first mortgage and two on the second. The new owner stalled the first mortgage holder (bank) for almost 18 months before they started the foreclosure process. A foreclosure by the senior mortgage meant that the second (junior) mortgage would be “extinguished” at the foreclosure auction. That's exactly what happened.

The buyer must have gotten mad at the bank, the seller, or was just a bad tenant and destroyed much of the interior of the home. The original seller got nothing for his second mortgage and no interest on his phantom profit of \$175,000 because the foreclosure wiped it out. The original seller grossed about \$285,000 for his property because he also paid the closing costs for the buyer and attorney's fees to try to get payments made on his second, but he owed \$280,000 so his net profit was \$5,000 or less.

The seller would have been better off to take the original offer I made him as he would not have had the aggravation that continued after he sold the property. He was a stubborn man who, after the closing on his sale, bragged to the neighbors how he personally created a new comparable in the neighborhood and they should “kiss his grits” for it! He was right about that.

He did create a new comp and his sale was most instrumental to my selling a couple of more properties in that sub-division for much more money than I could have gotten otherwise. I thank him for that, but ultimately he was the loser in this ego game he played trying to get the last dollar out of his property.

So what were his alternatives? This depends on how badly the seller wants his remaining equity out of the property when he sells. In this case he had about \$20,000 net equity after paying off his existing mortgage. The seller didn't need the money because it wasn't a life altering amount to him. If he had had tons of equity and needed the money, he should have cashed out and not risked taking a seller note back. I say that because it is increasingly easy to fight foreclosures in judicial and non-judicial states because of advanced legal tactics by attorneys attacking the lender's (conventional or private) legal right to get repaid.

While it's easy to look back and second guess someone, I would suggest the following:

1. Seller should have found a buyer who had a down payment (10% - 20%), could get financing (credit and income qualified) and, most importantly, get realistic about the value of the property. I understand that every seller wants every possible dollar out of his property, but often this isn't reasonable.
2. Seller should have considered a lease option instead of the outright sale so he could have evicted the tenant/buyer instead of having to go through a foreclosure – which he couldn't afford to do. The lease option is very viable if the real estate market is flat or rising. It doesn't work all that well in declining markets as the optionee likely will not exercise and the owner will have to re-lease option the property.
3. Sign a Standard Purchase and Sale Agreement for 1 – 2 years in the future with the perspective buyer putting down a non-refundable deposit that is as large as possible. The buyer should have a lease with the owner so he can be evicted if necessary. If this sounds a lot like a lease option, it is but there is no option agreement that may have to be adjudicated by the courts in a dispute. Additionally, some states are heavily regulating lease options because of abusive tactics by sellers.

In summary, I tell my students that if I own a property and someone (often an investor) comes by with a full asking price offer but with seller financing only, I offer them a lease option for one year instead. Owner financing is wonderful if you are the buyer, for the seller it can be a mine field in the future. If you are considering doing owner financing, make certain that your mortgage doesn't allow for junior liens on the property so that the buyer doesn't add an equity line or a second mortgage and walk away from the property and you have to repay the new junior lien or lose your property.

To your limitless success,

Dave Dinkel