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# NEW

# RULES

GOVERN CONTRACTS FOR DEED

**E**ffective Sept. 1, 2001, new rules govern both existing and newly executed contracts for deed, which place greater burdens on residential lenders and brokers. Failure to comply with the new provisions subjects sellers who finance residential loans, lenders and brokers to a Deceptive Trade Practices Act (DTPA) violation and in some cases as much as \$500 per day in damages.

## Two Types of Financial Arrangements

Owners or lenders can finance the sale of real estate and retain a security interest two ways. The most common is a real estate lien note secured by a deed of trust. The other is a promissory note secured by a contract for deed. Both methods have advantages and disadvantages for lenders and buyers.

Buyers prefer the deed of trust. At closing, the buyer receives both title and possession of the property. If a default occurs, the lender may foreclose under strict statutory guidelines to divest the buyer of both title and possession. If the foreclosure sale generates a surplus, the excess goes to the buyer.

In the past, lenders preferred the contract for deed, sometimes referred to as a *contract of sale* or an *executory contract for conveyance*, which was used frequently with seller financing. At closing, the buyer took possession but not title to the property. The seller retained title until all or part of the promissory note was paid. If the buyer defaulted, the lender accelerated the promissory note, terminated the contract, regained possession and retained all payments made by the buyer. Nothing resembling a foreclosure sale, in which excess proceeds go to the buyer, took place.

By making changes to the Texas Property Code (TPC), Texas legislators came to the aid of buyers who purchase a home using a contract for deed. For this reason, after Sept. 1, 2001, lenders, sellers and brokers may prefer deeds of trust over contracts for deed. However, lenders and sellers should be aware that the law changes the rules for existing contracts for deed, too.

## Application of New Law

The new rules apply only to transactions using a contract for deed to purchase residential property (lots of one acre or less are



presumed to be residential). Not covered are land sales by the State of Texas, by the Texas Veteran's Land Board or transactions in which the deed is delivered within 180 days. The rules apply to sales between closely related individuals as long as the buyer does not waive the statutory requirements in writing.

The language requirement under the new law for contracts negotiated on or after Sept. 1, 2001, may prove formidable for some sellers and brokers. The law states, "If the negotiations that precede the execution of an executory contract are conducted primarily in a language *other than English*, the seller (or broker) shall provide a copy *in that language* of all written documents relating to the transaction . . ." This means that precontractual notices, the contracts and all post-contractual notices, *et cetera* may need to be drafted in Spanish, Vietnamese, Chinese, Hindi, Arabic, Korean or other languages.

## Precontractual Notices

The new rules burden the seller (or broker) with many precontractual disclosures and documentations not required under deeds of trust. These notices apply to contracts negotiated and some contracts entered on or after Sept. 1, 2001. Non-compliance subjects the seller and possibly the broker to a private or public DTPA violation and allows the purchaser to cancel and rescind the contract. A rescission entitles the buyer to a full refund of all payments made pursuant to the contract. The seller or broker must provide the buyer with the following disclosures under the contract for deed.

- A survey less than a year old or a plat of a current survey of the property.
- A list of all transactions in the chain of title affecting the property, including all encumbrances, restrictive covenants and other claims.
- A Seller's Disclosure of Property Condition Form with the heading, "WARNING, IF ANY OF THE ITEMS BELOW

HAVE NOT BEEN CHECKED, YOU MAY NOT BE ABLE TO LIVE ON THE PROPERTY.” The form covers items such as the availability of potable water, sewers, electrical service and septic tanks. Other disclosures include the maintenance of roads, locations in floodplains, liens on title, whether other individuals besides the seller own an interest in the property and whether restrictions prohibit the construction of a home.

- A Seller’s Disclosure of Tax Payments and Insurance Coverage Form containing a tax certificate from the tax collector’s office for the property plus a legible copy of any insurance policy or binder.
- A Seller’s Disclosure of Financing Terms Form, similar to a truth-in-lending statement, indicating the purchase price, the interest rate of the promissory note, the total dollar amount of interest charged throughout the term of the contract, the total amount of both the principal and interest to be paid under the contract and the amount of any late-payment fees that can be assessed. No prepayment penalties can be charged under the contract for deed.
- An Oral Agreements Prohibited Statement stating in 14-point uppercase, boldface type that the contract cannot be modified by oral agreements of the parties. This notice can be a part of the precontractual notices or a part of the contract.
- If the property is not in a recorded subdivision, the seller must provide the purchaser with a separate disclosure form stating that utilities may not be available until the subdivision is recorded as required by law. Any advertisements of the property must disclose the availability of water, sewage and electrical service.



**UNDER THE NEW LAW,** if negotiations are conducted primarily in a language other than English, all documents must be drafted in that language.

deliver or send it to the seller to cancel the contract during the 14-day period.

- If not in the precontractual notices, an Oral Agreements Prohibited Statement as described earlier must be in the contract.

Just as certain items must be placed in the contracts, the statute limits or prohibits the inclusion of others. For example, if late payment fees are included in the contract, they may not exceed the lesser of 8 percent of the monthly payment or the actual administrative cost of processing the late payment.

Likewise, the contract cannot prohibit the purchaser from pledging the buyer’s interest as security for utility improvements or fire protection improvements. For contracts entered before Sept. 1, 2001, the purchaser could pledge the property only to obtain a loan to improve the property or to improve

the safety of the property. Finally, the contract may not impose prepayment penalties or any similar fee if the buyer elects to pay the entire amount before the maturity date.

## Contractual Maintenance

After the contract is signed, the law imposes four more requirements on the seller during the term of the contract.

- If the contract is terminated for any reason during the 14-day cooling-off period, the seller must record the instrument terminating the contract. The seller also must return the executed contract to the buyer along with any property or payments received at the inception of the contract. Likewise, the seller must cancel any security interest arising out of the contract within ten days after receiving the cancellation notice.
- If the contract was entered after Sept. 1, 2001, and not cancelled during the 14-day period, the seller must record the contract for deed along with all the precontractual disclosures within 30 days from the date the contract was executed.
- Effective Sept. 1, 2001, all sellers and lenders under contracts for deed are required to send an “Annual Accounting Statement” to the buyers disclosing the amount paid under the contract, the remaining unpaid balance of the note, the remaining number of payments, the taxes paid on the purchaser’s behalf, the amount paid to insure the property, any insurance proceeds received during the year if the property was damaged and evidence of any change in insurance coverage for the property. If the notice is mailed, it must be postmarked no later than January 31. This accounting statement will most likely need to be written in the language used to negotiate the contract.

Although annual accounting statements are required for all contracts for deed, the penalties apply only to violations occurring on or after Sept. 1, 2001. For these contracts, a violation entitles the buyer to \$250 in daily damages until the accounting statement is provided. Also, the

## Contractual Requirements

In addition to precontractual disclosures, the statute describes three provisions that must be included in the contract for deed. Again, these requirements apply to contracts on which negotiations began on or after Sept. 1, 2001.

- Notice of buyer’s right to cancel contract within 14 days. To ensure buyers are aware of the right to cancel, the contract for deed must contain a notice in 14-point boldface type or in 14-point uppercase typewritten letters. The notice, placed near the purchaser’s signature, must contain the following language: “YOU, THE PURCHASER, MAY CANCEL THIS CONTRACT AT ANY TIME DURING THE NEXT TWO WEEKS. THE DEADLINE FOR CANCELING THE CONTRACT IS (DATE). THE ATTACHED NOTICE OF CANCELLATION EXPLAINS THIS RIGHT.” The buyer may cancel the contract by signing and sending the notice to the seller by telegram, certified or registered mail or personal delivery.
- To reinforce the buyer’s right to cancel, a “Notice of Cancellation” form must be provided to the buyer when the contract is signed. The buyer need only sign this form and

buyer can recover reasonable attorney fees needed to collect the damages. This requirement, perhaps the most burdensome, may cause sellers and lenders to avoid the use of contracts for deed.

- The seller must promptly inform the insurer (the company issuing any insurance coverage on the property) of the name and address of the purchaser and the terms of the contract for deed. The insurer must be informed within ten days after either the coverage is obtained or the contract for deed is entered. For existing contracts for deed, lenders and sellers must notify the insurer no later than Jan. 1, 2002, to be in compliance and avoid a DTPA action. Any disbursements of insurance proceeds under the insurance policy must be issued jointly to the purchaser and seller and be used for repairs.

## Remedies in Event of Default

**T**he law defines a default under a contract for deed as the failure to make a timely payment or a failure to comply with terms of the contract. Placement of a lien on the property for utility service does not constitute a default. The new law dictates what the lender may do in the event of a default. The following provisions apply to all contracts for deed on which a default occurs on or after Sept. 1, 2001.

On default, the buyer no longer automatically forfeits all prior payments. The seller's remedies depend on whether the buyer has tendered 40 percent or the equivalent of 48 monthly payments. If less than 40 percent has been paid, the seller must send a notice by registered or certified mail, return receipt requested, to the purchaser's residence or place of business. The notice must be written in conspicuous 14-point boldface type or in 14-point uppercase typed letters that includes on a separate page 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), THE SELLER HAS THE RIGHT TO TAKE POSSESSION OF YOUR PROPERTY.

The notice must:

- Identify and explain the remedy the seller intends to enforce (this can be either rescission of the contract or acceleration and forfeiture).
- Specify in detail the amount in delinquency (itemized by principal and interest), any additional charges caused by the delinquency, such as late payments, and the period to which the delinquency and late charges relate.
- Specify the exact terms of the contract the buyer has breached if the default was caused by something other than failing to meet a payment.

After receiving the notice, the buyer has 30 days to pay the amount in default or to remedy the breach of the contract specified in the notice for contracts entered after Sept. 1, 2001. Otherwise, they have 60 days. If the buyer does not comply within the 30- or 60-day period, the seller may either rescind the contract by returning all the payments made by the buyer or accelerate the

note and cause a forfeiture of all the buyer's prior payments. Nothing similar to a foreclosure sale occurs. The seller selects which remedy to pursue in the default notice.

If more than 40 percent has been paid, the seller has only one option: to appoint a trustee to sell the property. However, the notice of default is not the same. The seller must send a 60-day notice worded as follows:

### 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.

The statute requires all notices to be written and sent in the language in which the negotiations were conducted.

The procedure for conducting the sale must comply with Section 51.002 of the TPC, the same law that governs foreclosure sales under deeds of trust. Among other things, the trustee must post, file and serve notice of the sale in the county where the property is located at least 21 days before the sale is conducted. The sale is conducted on the first Tuesday of the month after the 21-day period. For more information on foreclosure procedure see *A Homeowner's Rights Under Foreclosure* (technical report No. 825).

At the sale, the trustee conveys title to the purchaser and warrants that the property is free from encumbrance. Any proceeds that exceed the debt go to the buyer-in-default. Unless the contract for deed states otherwise, the purchaser-in-default is subject to the same collection procedures specified in Sections 51.003–51.005 of the TPC for any deficiencies resulting from the sale.

## Postcontractual Procedures

Sellers and lenders are required to convey legal title to the buyer and record the deed within 30 days after receiving the final payment. This requirement applies to all contracts. However, the following penalties apply only to contracts entered on or after Sept. 1, 2001. For these contracts, a violation entitles the buyer to \$250 per day starting on the 31<sup>st</sup> day and continuing until the 90<sup>th</sup> day. After that, daily damages rise to \$500 until compliance

occurs. The purchaser is entitled to reasonable attorney's fees needed to collect the damages and to secure title to the property. The daily penalties are suspended in instances in which title is being adjudicated following the seller's death.

Sellers or lenders who have used and who contemplate using contracts for deed to finance residential sales face tougher rules. The precontractual, contractual and postcontractual requirements are extensive and penalties for breaching them are severe. Buyers no longer forfeit past payments automatically on default. For these reasons, sellers and lenders may wish to use deeds of trust instead of contracts for deeds for financing sales of residential property. ♣



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