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DEAR REALTOR® FRIENDS:

CONSIDER this scenario: You are representing buyers. They have found their $300,000 dream home, but, because of a past problem with their credit, they do not qualify for a mortgage loan from any conventional lenders. But you know a "guy" … and this "guy" supplements his income by making mortgage loans to borrowers in this kind of situation. The individual lender initially offers a mortgage loan at 10% interest, amortized over 10 years. You know your buyers cannot afford the payments for such a loan. After extensive negotiations on behalf of your borrowers with the lender, you obtain a mortgage loan for your borrowers at 7%, amortized over 30 years with a 5 year balloon. Grateful, both the lender and the buyer give you $250 gift cards. The buyer, the lender, even the seller and the seller's agent, are extremely happy that you saved this deal. Everybody wins. You're a hero, right?

WRONG! You are probably in violation of the Dodd-Frank Act. On top of that, you have assisted the individual lender in violating the Dodd-Frank Act. Additionally, the buyer's note and mortgage obligations are probably invalid and unenforceable due to these violations of the Dodd-Frank Act.

WORRIED? You have no need to be. Just read our enclosed article:

SELLER-FINANCING RESTRICTIONS
UNDER THE DODD-FRANK ACT

NEED quick-reference guides to seller-financing under the Dodd-Frank Act? See our enclosures:

SELLER-FINANCING GUIDE UNDER DODD-FRANK
and
DODD-FRANK SELLER-FINANCING EXCEPTION COMPARISON CHART

We think these educational guides will be beneficial to both you and your clients. If you have any questions about this topic, please do not hesitate to call or e-mail us. As always, we will answer your questions at no charge. If you would like a copy of these guides emailed to you, please request one from our Firm Administrator, Connie Hoff, at CHoff@BarnesWalker.com.

For the Firm,

Garret T. Barnes *Adron H. Walker*

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SELLER-FINANCING RESTRICTIONS UNDER THE DODD-FRANK ACT

INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Consumer Financial Protection Bureau ("CFPB"), and with other laws, has expanded previous regulations concerning the licensing, training, screening, and compensation practices of loan originators, mortgage brokers, bank officers, and lenders in general, in consumer loan transactions.

On January 10, 2014, the Loan Originator Rule came into effect to implement the new Dodd-Frank requirements. This Rule was expanded to include certain restrictions on *seller*-financing in residential real estate transactions where the dwelling is secured by a mortgage, unless the *seller* is entitled to certain exclusions.

This Article is an attempt to explain these confusing (and conflicting) requirements of the laws—namely, the Dodd-Frank Act. This is a general outline, and because the laws are so new and untested, we will keep you informed as to changes and/or inconsistencies with this Article.

If you do not think this will impact your practice, think twice. For example, if you have a son or daughter who has a good paying job but no credit, who wants to buy a home, and you wanted to lend them money, you cannot lend money to that son or daughter to buy a residential property to use as their home and secure it with a mortgage without first obtaining a mortgage broker license. This is how impactful the new laws are.

What is a loan originator under the Dodd-Frank Act?

In very general terms, if the loan will be secured by a property that the borrower will use for residential purposes, then the person who arranges the loan is defined as a "loan originator," and must have a mortgage originator license. Seller-financers must be licensed mortgage originators <u>unless</u> they qualify for one of the two exceptions, which will be discussed below.

The Dodd-Frank Act defines mortgage originators as "any person who for direct or indirect compensation or gain or in the expectation of direct or indirect compensation or gain takes a residential mortgage loan application or offers or negotiates terms of a residential mortgage loan." Please note there are different definitions and rules under various Federal and State laws that apply to mortgage loan originators, and they are very difficult to comprehend and reconcile with each other. The loan originator rules under the Dodd-Frank Act, however, require that said persons be licensed, are subject to certain restrictions on compensation, and must comply with vague guidelines on proving the borrower's ability to repay.

Under the Dodd-Frank Act, any person who offers and negotiates terms of a *residential mortgage loan* is deemed to be a "mortgage loan originator" and must be a licensed mortgage broker in compliance with all laws, unless one of the seller-financing exceptions described below apply. There is no exemption for a person who is <u>not</u> a seller who wishes to make a loan secured by a residential mortgage. Lenders must be licensed mortgage brokers, or use the services of a licensed mortgage broker in connection with the loan. This applies only to mortgages that secure loans on residential dwellings containing one to four units, and includes houses, apartments, townhouses, condominium units, cooperative units, mobile homes, trailers and boats used as residences. The rules apply whether the individual is purchasing a primary residence, second home or vacation residence.

<u>NON-APPLICABILITY</u>

As indicated above, the Dodd-Frank Act applies only to residential mortgage loans.

1. Therefore, Dodd-Frank does not apply to loans secured by vacant land, commercial properties, rental properties or properties used for investment purposes. The rules also do not apply to residential properties on which the buyer does not intend to reside.

2. Further, Dodd-Frank does not apply to non-consumer buyers, even if the property being purchased is a residential property. Examples of non-consumer buyers are: corporations, limited liability companies, partnerships, etc.

   Thus, if Dodd-Frank does not apply as set forth above, you do not have to analyze whether the transaction meets one of the two exceptions discussed below.

<u>EXCEPTIONS</u>

Even if the transaction involves property being purchased by a consumer for their residence, the Dodd-Frank Act provides certain exceptions for sellers who wish to sell their property and take back a mortgage. Under these exceptions, the seller-financer will not fall under the definition of a "loan originator" if the seller and the financing terms meet certain criteria.

The two exceptions are as follows:

1. <u>First</u>, there is a **<u>one property exception</u>**. Under the first exception, a seller-financer who extends credit to a buyer as defined above, secured by a mortgage encumbering a residential dwelling, is *not*

considered a "loan originator" if:

(a) they are a natural person, estate, or trust;

(b) they provide financing for only one property in a twelve month period;

(c) they own the property securing the financing;

(d) they did not construct or act as the contractor for the construction of a residence on the property;

(e) the financing must have a repayment schedule that does not result in a negative amortization;

(f) balloon payments are allowed (not less than 5 years recommended to be conservative; however, there is apparently a two-year window, and after two years this allowance may terminate);

(g) the financing must have a fixed rate or an adjustable rate that resets after five or more years, and there are restrictions, limitations, and caps on rate changes and lifetime caps of rates; and lastly,

(h) the seller does not have to vet the borrowers or determine the borrower's ability to repay.

2. Second, there is a **three property exception**. Under this exception, the seller-financer is *not* considered a "loan originator" if:

(a) they are a natural person, estate, or trust, or an entity;

(b) they provide financing for three properties or less in any twelve month period;

(c) they own the property securing the financing;

(d) they did not construct or act as the contractor for the construction of a residence on the property;

(e) the financing must be fully amortizing and there must be no balloon payments or structures allowed;

(f) the financing must have a fixed rate or an adjustable rate that resets after five or more years, and must have caps on rate changes, and also lifetime caps.

(g) the seller must determine, in good faith, that the consumer has a reasonable ability to repay, and while the sellers are not required to formally document how they made their good faith determination that the buyer had the ability to repay, a prudent seller should keep records in case the analysis is ever called into question. This could include current or reasonably expected income or assets, income tax returns, employment, monthly payments, debt obligations, debt to income ratios, credit history, etc.

For both exceptions, adjustable interest rates must have reasonable annual and lifetime limits on rate increases and provide for the rate to be determined by the addition of a margin to an index rate based on a widely available index such as indices for U.S. Treasury securities or LIBOR. CFPB's Official

Interpretations note that an annual rate increase of up to 2 percentage points is reasonable. A lifetime rate cap or ceiling of 6 percentage points, up to any applicable usury limit, subject to a minimum floor, is reasonable. These "safe harbors" are not mandatory, but sellers would be wise to adopt them.

It is important to note that a corporation, partnership, or LLC can never avail itself of the one property exception, and may only use the three property exception. A potential loophole would allow for a corporation to convey the property in question to its individual members/owners, who could in turn provide seller-financing under the terms of the one property exception. However, taking advantage of such a loophole under the new laws is very risky, and not recommended at this point.

Additionally, no matter what, under either exception there can be no mandatory arbitration, and the parties cannot waive any of the Dodd-Frank requirements or restrictions.

3. There is an additional exception for lenders or sellers who finance less than six dwellings in a twelve-month period. Under this exception, these lenders are not considered "creditors,"[1] and are exempt from the ability-to-repay provisions under 12 CFR §1026.43. However, they are still considered "loan originators" for purposes of the licensing and compensation requirements, and must still comply with other relevant provisions under Dodd-Frank. Therefore, seller-financers should rely only on the first two exceptions described above. As mentioned, the laws and definitions are very confusing and unclear.

4. Lastly, there are other exceptions for qualified mortgages, but they are very complicated and allow only for a presumption that the ability-to-repay requirements have been met. As a practical matter, these exceptions do not assist local seller-financers.

LEASE OPTIONS

A lease option contract where an owner rents out residential property to a tenant and gives the tenant an option to purchase the property after a specified period may also be subject to the new Dodd-Frank Act, if any of the rental payments are used as a credit toward the purchase price or create ownership equity in the property.

FIX TO FLIPS

There may be some restrictions on a person who purchases a property, fixes it up, flips it quickly, and takes back financing from the buyer, in that the seller may be considered a contractor. Such a seller should still adhere to one of the above exceptions, particularly if the renovations required the seller to obtain building permits. The rules do not apply, however, to a seller who extends financing to an investor-buyer who does not intend to reside on the property.

DOUBLE CLOSING

One way to possibly make closings happen with an individual owner/lender is to have two closings in which the seller-financer first buys the property, so then he or she can immediately sell it to, and finance it for, the borrower, subject to the limitations contained in the exceptions. However, you have to deal with two

[1] 12 CFR 1026.2(a)(17) A "creditor" is a person who "regularly extends" consumer credit. "A person regularly extends credit only if it extended credit … more than five times for transactions secured by a dwelling in the preceding calendar year."

closing costs and other risks. The contract would have to be assignable as well.

This potential loophole carries a risk, however. There is a general rule of law that one cannot do indirectly what is prohibited directly, especially if one acts repeatedly in the same way, creating a pattern.

A GOOD SOLUTION

So, what if Dodd-Frank applies to a seller-financer or an individual lender, and that seller-financer, the individual lender, or the transaction does not meet the requirements of either the one-property exception or the three-property exception? Do you abandon the deal? No. It will cost the seller and/or the buyer some money, but the seller (or the individual lender, if not the seller) or buyer can contact a licensed, independent loan originator who we all know as a mortgage broker. Dodd-Frank allows a seller-financer or individual lender who does not otherwise comply with Dodd-Frank to still provide mortgage loans if they provide the loans through a mortgage broker, provided further that the mortgage broker complies with all of the various lending laws and regulations, including but not limited to, the Dodd-Frank Act, the SAFE Act, RESPA, the Truth In Lending Act, and Regulation Z. Since the mortgage broker will be lending the seller-financer's or individual lender's money, the broker may be considered the agent of the seller-financer or individual lender, in which case, the latter will be potentially liable if the former fails to comply with all of the lending laws and regulations. Therefore, the seller-financer or individual lender should use only a competent and knowledgeable mortgage broker.

PUNISHMENT FOR VIOLATIONS

What happens if there is a violation of the Dodd-Frank Act and other related laws? The penalties are very harsh if there is a violation of the various federal requirements, including the Dodd-Frank Act, the SAFE Act, RESPA, and the Truth In Lending Act, in that there could be a private right to sue for violations and to be reimbursed attorneys' fees and costs, penalties of up to $4,000.00 to $5,000.00 per day at a minimum, $25,000.00 for reckless violations, and $1,000,000.00 per day for knowing violations. There could also be actions against the violator such as rescission or reformation of contract, refund of borrower costs, return of interest paid, return of real property, restitution, disgorgement or compensation for unjust enrichment, private damages, other monetary relief, and other relief currently undefined.

You have to be very careful in that the Act targets not just owner/lenders and seller-financers, but it is also a danger to real estate agents who arrange for credit and set up a loan, particularly if the agents receive compensation. In such cases, these agents might also be considered loan originators and have to be licensed under the new laws. This risk changes Realtors'® normal and historic business model, as they often help borrowers locate and find different forms of financing for properties. Providing clients with uncompensated general information about mortgages or lists of reputable lenders, though, does not appear to bring a real estate agent or broker under the definition of a loan originator. However, if an agent's or broker's efforts exceed these acts, there could be some liability.

QUICK-REFERENCE GUIDES

At this point, are you wondering if there is some simple way of deciding whether a seller-financer needs to be licensed as a loan originator? Yes, there is: Attached, please find the **Barnes Walker Seller-Financing Guide Under Dodd-Frank**.

Do you need a chart that compares side-by side the requirements of the one-property exception and the three-property exception? If so, see the **Barnes Walker Dodd-Frank Seller-Financing Exception Comparison Chart** attached hereto.

UNCERTAINTY

Dodd-Frank, the CFPB's implementing rules, and the related laws are very new and untested, and therefore, there is a lot of uncertainty as to how they may be applied. In addition, their wording is very broad, complicated, and vague, and, in a lot of areas, inconsistent with other definitions and provisions of various federal regulations. These laws and rules have also yet to be tested in the courts, and governmental agencies have not provided clarity on some of the inconsistencies and vague requirements.

Therefore, you want to be very careful and stay within the "black letter" areas of the laws and rules, utilizing their "safe harbors" as much as you can and not pushing the edge of the envelope. There is talk about ways to take advantage of possible loopholes in the laws and the rules, such as using different land trusts and creating multiple LLC's, but they are untested, and you do not want to be a "test case" against the federal government.

If you have any further questions about the Dodd-Frank Act, please do not hesitate to call or email us at (941)741-8224 or GBarnes@BarnesWalker.com. As always, we will answer your questions at no charge.

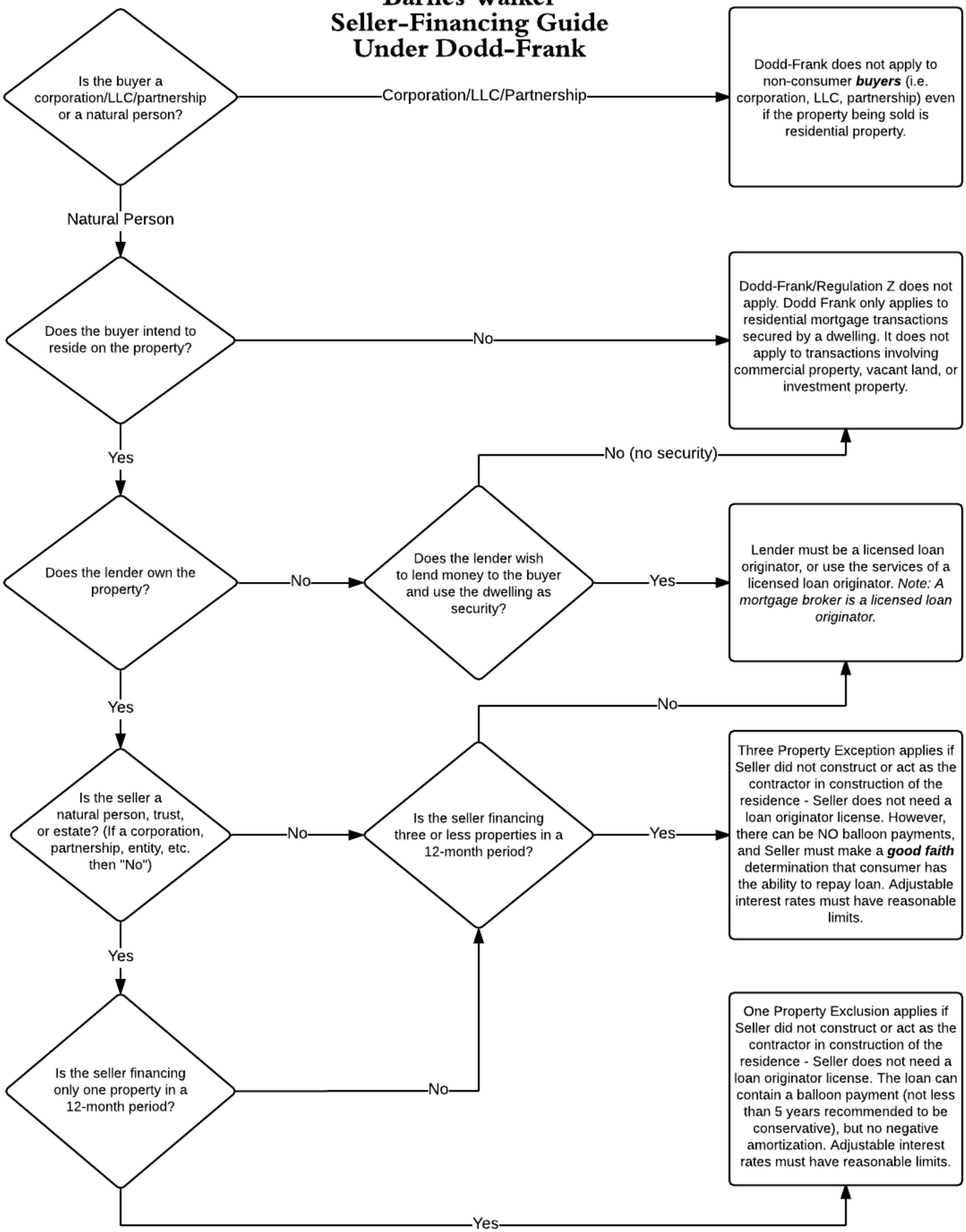
For the Firm,

Garret T. Barnes *Adron H. Walker*

Important Note:

The information contained in the preceding article is summary in nature and is given for educational purposes only. This article should not be considered as legal advice for your situation, if any, nor is it intended as specific or detailed advice, as <u>we do not have any information specific to your situation</u>. Further, the preceding article is not intended to be an all-inclusive discussion of the provisions of the Dodd-Frank Act, but a guide to the same, and there may be other matters not described in the article which may impact your particular situation. Therefore, always seek legal advice regarding your own, unique situation. Finally, this article is intended as a public service and is not a solicitation seeking legal employment of our firm by you or your clients.

Barnes Walker
Seller-Financing Guide
Under Dodd-Frank



This chart is intended for educational purposes only.

DODD-FRANK SELLER-FINANCING EXCEPTION COMPARISON CHART[2]

	ONE PROPERTY EXCEPTION *(No License Required)*	THREE PROPERTY EXCEPTION *(No License Required)*	MORE THAN THREE TRANSACTIONS *(Requires Mortgage Loan Originator License)*
Seller is the owner of property and:	Is a natural person, trust, or estate only.[3] Is *not* an entity, corporation, LLC partnership, or proprietorship. Did not construct or act as the contractor in the construction of, the residence in the ordinary course of business.	Is a natural person, trust, or estate OR any entity, including a corporation, LLC, partnership, or proprietorship. Did not construct or act as the contractor in the construction of, the residence in the ordinary course of business.	Any individual or entity.
Type of property	Applies to dwellings that buyer intends to reside in (includes vacation homes and second homes). Note: Dodd-Frank does not apply to vacant land, commercial property, rental property, or multi-family and single-family residences where the buyer does NOT plan to reside.	Applies to dwellings that buyer intends to reside in (includes vacation homes and second homes). Note: Dodd-Frank does not apply to vacant land, commercial property, rental property, or multi-family and single-family residences where the buyer does NOT plan to reside.	Applies to dwellings that buyer intends to reside in (includes vacation homes and second homes). Note: Dodd-Frank does not apply to vacant land, commercial property, rental property, or multi-family and single-family residences where the buyer does NOT plan to reside.
Number of Transactions	Seller finances only ONE residential property in a 12-month period, and retains a security interest in the dwelling.	Seller finances THREE or less properties in a 12-month period, and retains a security interest in the dwelling.	Seller finances more than 3 properties in a 12-month period, and retains a security interest in the dwelling.
Mortgage Requirements	Note can contain balloon payment, but no negative amortization. Adjustable interest rates must have reasonable limits.	NO balloon payment allowed. Adjustable interest rates must have reasonable limits.	MUST BE A LICENSED MORTGAGE ORIGINATOR OR USE THE SERVICES OF A LICENSED ORIGINATOR.
Ability to Pay Requirements	No requirement for determining ability to pay.	Seller must determine in ***good faith*** that consumer has ability to pay. Documentation not required, but recommended. Request evidence such as income tax returns. However, the value of the dwelling that secures the financing CANNOT constitute evidence of ability to repay.	MUST BE A LICENSED MORTGAGE ORIGINATOR OR USE THE SERVICES OF A LICENSED ORIGINATOR.
Interest Rate	Must be fixed or adjustable after 5 years.	Must be fixed or adjustable after 5 years.	MUST BE A LICENSED MORTGAGE ORIGINATOR OR USE THE SERVICES OF A LICENSED ORIGINATOR.

[2] This chart is intended for educational purposes only.
[3] A corporation can never avail itself of the one property exception, and may only use the three property exception.