

2005 Updates: Rules Govern Contracts for Deed

Background

In 2001, the Texas Legislature implemented protection for purchasers under contract for deeds on a statewide basis. This augmented earlier attempts in 1995 that limited protection to purchasers in counties along the border. In 2005, the 79th Texas Legislature again strengthened the safeguards for purchasers, eliminating many of the problems that emerged after the 2001 changes. Some of the measures became effective Sept. 1, 2005, while others became effective Jan. 1, 2006.

The 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.

The first part of this article discusses the rules that apply after Sept. 1, 2001, with noted exceptions. The second part discusses the new rules that became effective either Sept. 1, 2005, or Jan. 1, 2006.

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 2005, 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 (VLB) or transactions in which the deed to the property is delivered within 180 days after the contract is entered. The rules apply to sales between closely related individuals (within the second degree of consanguinity) as long as the buyer does not waive the statutory requirements.

Effective Jan. 1, 2006, the following conveyances are covered by the statute:

- the sale of state land,
- the sale of land by the VLB or by the state or its political subdivision or
- the sale of land by an instrumentality, a public corporation or other entity created to act on behalf of the state or its political subdivision.

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. Noncompliance 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.

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 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.

For contracts entered after Sept. 1, 2005, the contract may not contain provisions that cause the purchaser to forfeit an option fee or other option payment as a penalty for late payments. Likewise, the contract may not increase the purchase price, impose a fee or charge or otherwise penalize a purchaser for requesting repairs or for exercising other rights of a tenant under a lease-purchase option discussed later. None of these provisions, including those mentioned in the prior two paragraphs, can be waived after Sept. 1, 2005.

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. Effective Sept. 1, 2005, the penalty depends on the number of contract-for-deed transactions entered by the seller. Sellers who enter no more than one transaction during any 12-month period are liable for \$100 in liquidated damages to each purchaser who does not receive the annual accounting statement by Jan. 31 of each year. The purchasers may also recover reasonable attorney's fees.

Sellers who enter more than one transaction during any 12-month period are liable in liquidated damages for \$250 per day for each day the statement is not provided after Jan. 31 of each year. The liability cannot exceed the

fair market value of the property. The purchasers may also recover reasonable attorney's fees. 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

The 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 31st day and continuing until the 90th 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.

Latest Changes Implemented by the 79th Texas Legislature

The new law expands the types of transactions covered by the statute. Basically, the rules apply only to real property used or to be used as residential property. However, any lot one acre or less is presumed to be a residential transaction. Effective Jan. 1, 2006, the law covers residential leases combined with options to purchase, regardless of the size of the

tract. These lease purchase options (LPOs) are now considered contracts for deeds and have special rules.

For example, certain provisions of the statute *do not* apply to LPOs. These include the sections of the statute listed in Special Exceptions, below. Other sections of the statute apply *only if* the option to purchase (*contract*) is for three years or less, and the purchaser and seller (or their agents, assigns or affiliates) have not been parties to a contract to deed covering the same property for more than three years. These sections are listed in Specific Provisions, below.

The statute says the previous sections of the law apply only if the “*contract*” is for three years or less. LPOs include two contracts; one is the residential lease, the other the option to purchase. It is unclear to which “*contract*” the statute refers.

After the LPO is entered but before the tenant-buyer exercises the option to purchase, the parties are subject to the same rules that govern the landlord-tenant relationship as provided in Chapter 92 of the Property Code. (See *The Landlords’ and Tenants’ Guide*, Real Estate Center pub. 866.) Before the option to purchase is exercised, the contract for deed may not increase the price, impose a fee, charge or otherwise penalize the purchaser for requesting repairs or exercising any rights of a tenant under Chapter 92.

In addition, the contract provisions may not allow the tenant-buyer to forfeit an option fee because of a late payment. These two provisions may not be waived.

Interestingly enough, the statute implemented the changes regarding LPOs but included no penalties for violating any of the provisions.

New Statutory Penalties for Annual Accounting Statements

The statute changes the penalties imposed on sellers who fail to provide the annual accounting statements discussed earlier and found in Section 5.077 of the Property Code. The new penalties apply to all contracts in existence on Sept. 1, 2005, and any entered thereafter.

Buyers’ Right to Convert to Deed of Trust

Perhaps the most sweeping change implemented by the new law gives the purchasers’ the right to convert the contract to a deed of trust at any time without penalties or charges. This right applies to all contracts in existence on Sept. 1, 2005, and any entered thereafter.

The first step in the process requires the purchaser to tender the amount owed under the contract to the seller in the form of a promissory note. The note must contain the same interest rate, due dates and late fees as described in the contract.

Within ten days after the tender is made, the two parties must mutually agree on the day and time to simultaneously exchange the following documents.

The seller delivers an executed, recordable deed conveying the property to the buyer with the warranties required by the contract. In turn, the buyer delivers to the seller a deed of trust that:

- contains the same terms as the contract regarding the duties of the purchaser and seller,
- secures the purchaser’s payment and performance under the note and deed of trust and
- conveys the property to the trustee, in trust, and confers on the trustee the power of sale in the event of default.

The appropriate legal forms for making this conversion are those published by the Texas Real Estate Commission, even though the commission has not drafted any forms for such a transaction.

The exchange of the documents effectively voids or terminates the contract for deed. Thereafter, the deed of trust governs the rights and responsibilities of the parties.

If the seller refuses to comply with the conversion after receiving the purchaser’s promissory note, the seller must provide a written explanation to the purchaser within ten days legally justifying the refusal. Any violation of these provisions subjects the seller to \$250 liquidated damages for each day the seller fails to comply, beginning the 31st day after the seller receives the promissory note and ending 90 days thereafter. Reasonable attorney fees are included.

To expedite the conversion process, the new law provides a means for the purchaser to determine the balance owed on the contract and the name of the prospective trustee for purposes of drafting both the promissory note and deed of trust.

Within ten days after receiving a written request, the seller must provide the:

- amount owed on the contract on the date the requested and
- name and address of the person the seller wishes to serve as trustee under the deed of trust.

The seller’s failure to respond within the ten days permits the purchaser to determine the amount owed under the contract for purposes of drafting the promissory note and the right to select the trustee. However, the trustee the buyer selects must live or have a place of business in the same county where the property is located.

The seller may protest the amount the purchaser claims is owed under the contract by sending a written objection by regular or certified mail. The protest must be sent within 20 days after the seller obtains knowledge of the amount claimed by the buyer. The protest must include the amount the seller claims is owed based on written records kept by the seller or the seller’s agent that were maintained and regularly updated during the entire term of the contract.

Under either scenario, the purchaser, without taking judicial action, may deduct the amount owed to the purchaser by the seller under the terms of the contract.

Right to Cancel for Improper Platting

The new law grants purchasers the right to cancel and rescind a contract at any time if the purchaser learns that the seller has failed to properly subdivide or plat the property according to state and local law. To facilitate the purchaser’s ability to gain this knowledge, Texas legislators amended Section 212.0115(c) of the Texas Local Government Code. Now the purchaser under a contract for deed may make written request to the proper authorities to determine whether a plat is required for the land in question. If a plat is required, the authorities must disclose if one has been prepared, reviewed and approved.

To cancel and rescind the contract, the purchaser delivers written notice to the seller one of three ways: (1) personally (2) by telegram or (3) by certified or registered mail, return receipt requested. Within ten days after receiving the notice, the seller must deliver to the purchaser in one of the three ways listed previously:

- a signed, written notice that seller intends to subdivide or plat the property or
- return all payments of any kind received from the purchaser and reimburse the purchaser for the property taxes he or she paid during the contact as well as for the value of improvements added to the property.

Until all the payments and expenses have been returned and reimbursed, the seller may not terminate the purchaser's right of possession.

However, if the seller opts to plat the property, he or she must do so within 90 days after receiving the notice to cancel and rescind. Before the end of the 90 days, the seller must also provide the purchaser written evidence that the platting was completed in accordance with state and local law. The written evidence must be delivered in one of the three ways mentioned earlier.

Maintaining Fee Simple Title Free of Liens

After Sept. 1, 2005, the law prohibits sellers from selling property using a contract for deed when the seller does not own the property in fee simple, free and clear of any liens or encumbrances. If a contract is entered, the seller and the seller's heir and assigns must, throughout the duration of the contract, maintain the property in fee simple, free and clear of any liens or encumbrances except for those:

- caused by the purchaser's conduct,
- used by the purchaser to improve the property for such things as utility and fire protection and
- acquired by the seller to purchase the property (purchase-money mortgage) prior to entering the contract for deed with the buyer.

The statute stipulates four conditions for the purchase-money-mortgage-lien exception to apply. First, within three days before the contract of deed is signed (executed), the seller must inform the purchaser in a separate written document of the:

- name, address and phone number of the lienholder or mortgage servicer,
- loan number and the outstanding balance of the loan and
- date and the amount of each monthly payment.

In the same document, the seller must disclose in 14-point type that the lienholder may foreclose on the property if the seller fails to make timely monthly payments.

Second, the purchase-money mortgage lien must attach only to the property being sold under the contract for deed, and to no other property. Also, at no time can or will the amount of the indebtedness owed under the contract for deed exceed the balance owed under the purchase-money mortgage. This eliminates any owner financing using a second lien on the property.

Third, the lienholder under the purchase-money mortgage must allow the property to be encumbered with a subsequent contract for deed. Also, the lienholder must agree to verify the status of the loan to the purchaser upon request and to accept payments directly from the purchaser if the seller defaults.

Fourth, the following three covenants and/or warranties must be placed in the contract. The first obligates the seller to:

- make timely payments to the lienholder,
- render monthly statements to the purchaser reflecting the amount paid and the date the lienholder received the payment(s) and

- restate the items listed earlier under the first of these four requirements.

The second obligates the seller to inform the buyer within three days of acquiring knowledge or receiving notice regarding a default, an acceleration or foreclosure by the lienholder or mortgage servicer on the purchase-money mortgage.

The statute does not dictate the method of communicating this information, but it must be placed in 14-point type and be attached to copies of all related documents.

The third allows the purchaser, without notice to the seller, to:

- cure any deficiencies with the lienholder when the seller defaults and
- deduct from the balance owed under the contract for deed, 150 percent of the amount so paid without taking any judicial action.

The statute contains specific penalties for violating these requirements. In addition to other rights and remedies provided by law, the purchaser may:

- cancel and rescind the contract basically under the same rules discussed earlier when the seller fails to plat the property and
- sue the seller under the Deceptive Trade Practices Act (Chapter 17 of the Texas Business and Commerce Code).

However, the seller does violate the statute when:

- someone other than the seller places a lien on the property and
- the seller removes the lien within thirty days after receiving notice of its existence.

SPECIAL EXCEPTIONS

The following provisions in the Texas Property Code do not apply to contract for deeds when tied to lease-purchase options. These can be found at <http://www.capitol.state.tx.us/statutes/statutes.html>.

- (1) Section 5.066,
- (2) Section 5.067,
- (3) Section 5.071,
- (4) Section 5.075,
- (5) Section 5.081 and
- (6) Section 5.082.

SPECIFIC PROVISIONS

The following provisions in the Texas Property Code apply to contract for deeds when tied to lease-purchase options only when the contract is for three years or less and the purchaser and seller (or their agents, assigns or affiliates) have not been parties to a contract to deed covering the same property for more than three years. These can be found at <http://www.capitol.state.tx.us/statutes/statutes.html>.

- (1) Section 5.063,
- (2) Section 5.064,
- (3) Section 5.065,
- (4) Section 5.073 (except for Section 5.073(a)(2),
- (5) Section 5.083 and
- (6) Section 5.085. 📌



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