Law Office of
KEVIN F. JURSINSKI
& Associates

DODD FRANK ACT UPDATE – SELLER FINANCING RESTRICTIONS & EXCEPTIONS

By: Attorney Kevin F. Jursinski, B.C.S.
September 2015

This Article will update revisions to the Dodd Frank Act and the previous Article that I wrote titled "The Unintended Consequences of Dodd Frank" published in the Florida Business Observer on May 31, 2013.

This Article focuses on purchase money financing in which a Seller of a residential unit creates Seller financing allowing the Purchaser to have ability to immediate access to a loan transaction without going through an institutional lender or third party lender. Dodd Frank created some significant restrictions on such Seller Financing and as a result of a large outcry there have been certain exceptions created to Dodd Frank as to seller financing.

Here is an update to changes made:

1. GENERAL OVERVIEW

Pursuant to the Dodd Frank Act, any person who offers or 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 regulations promulgated by Dodd Frank unless specific Seller financing exceptions allowed under Dodd Frank are met.

Therefore, the fundamental approach should be to first to identify whether there are scenarios and exceptions to allow Seller financing on the sale of property. In order to understand these, we must go through the series of exceptions allowed under Dodd Frank.

2. DODD FRANK ACT ONLY APPLIES TO CONSUMER RESIDENTIAL MORTGAGE LOANS.

Dodd Frank does not regulate purchase money financing for the sale of lots (even if single-family residential lots), commercial properties, investment properties such as duplexes, rental properties or other income producing properties. The Dodd Frank Act also does not apply to residential properties which are being sold and in which the Purchaser is not intending to occupy as the Borrower's residence. It is not clear at this point in time because no case law has been generated, as to the interpretation of all of these exceptions and their application to specific fact patterns.

By way of example, would a sale of a single-family unit with purchase money financing result in an exception if the prospective Purchaser intended to:

a. Use the property in part as a rental and in part as a vacation home? And, if so, what is the time period allowed before it is considered a true residence of the Borrower? Note Section 1026.2(a) 19 of the Act identifies dwelling and residence as follows:
Dwelling means a residential structure that contains one to four units, whether or not that structure is attached to real property. The term includes an individual condominium unit, cooperative unit, mobile home, and trailer, if it is used as a residence.

b. Using this example, is the IRS exception for use of a vacation home applicable under Dodd Frank? Would the single family unit for more than 14 days result in it being classified as a "residence" under Dodd Frank?

c. What period of time would create an issue?

d. When is the intent determined? At the time of sale? Within a reasonable period of time after the sale if the Purchaser converts to full time residency?

Note: Mobile homes, boats and trailers can, in fact, be a "residence" falling under the provisions of the Act. RVs, Campers and the like not used a residences are not dwellings under the Act.

Assuming an agreement was entered into in which there were good faith representations by the prospective Purchaser that the unit was not to be utilized for a residence but then the Purchaser changed his mind and moved into the residence. Would Dodd Frank then be retroactively applicable if this was a decision made solely by the Owner and not a situation in which the Seller and Owner created a false scenario of non-residential use to circumvent Dodd Frank?

Most of the attorneys that I speak with as well as most of the sophisticated investors all have concerns because there is no certainty as to how the Courts will ultimately interpret specific provisions of Dodd Frank as relate to purchase money financing scenarios. It has been identified that there has already been written more than 5,000,000 words of regulations written interpreting the Dodd Frank Act, comprising more than 13,000 pages of regulations. A fear that fellow attorneys and investors have is that somewhere buried in those rules and regulations will be a land mine which could be interpreted by the Court in a manner which could be detrimental to the Seller providing purchase money financing.

3. DODD FRANK ACT DOES NOT APPLY TO NON-CONSUMER BUYERS OF RESIDENTIAL PROPERTY.

This overarching concept eliminates the application of Dodd Frank on purchase money financing when it is sold by a Seller to a corporation, limited liability company, partnership or other business entity. Again, there are many scenarios which may create a situation in which a purchase money financing exception may be utilized and fall outside the provisions of Dodd Frank.

By way of example, assume that an individual wanted to purchase a home using Seller financing but there is inability on the Seller to implement Seller financing (Seller constructed the home or Seller was a business entity and does not meet the 1 sale or 3 sale exception (see discussions below). Is it possible that Buyer, intending to use this as his residence, could create an entity (corporation, limited liability company, partnership, Florida Land Trust) to take title to the property thereby eliminating the application of the Dodd Frank Act? These are concepts and ideas which haven't yet been tested or interpreted. Many attorneys also fear that creating exceptions to the law by setting up entities to avoid the application of law might be interpreted by the Court as a form over substance and result in severe penalties being imposed under Dodd Frank for attempting to circumvent the Act. Therefore, the government regulations imposed creates uncertainty and the inability to confidently conduct business.

4. SPECIFIC RESTRICTIONS PRECLUDING THE BUILDER OF THE PROPERTY TO ACT AS SELLER.

A preclusion exists indicating that a corporation, partnership or limited liability company cannot avail itself to the one (1) property exception but can qualify for the three (3) property exception as discussed below. Again, construing the law on its face, is it possible then to create a scenario where a business entity (corporation, partnership, limited liability company, etc.) conveys the underlying property to its members in proportion to their ownership interest (corporate distribution of corporate real property) thereby creating title in the name of individuals rather than the entity that either a) constructed or b) held title to the residential property and, if so, would that allow individual(s) holding title in his/her/their own name(s) to exercise the right to utilize the one (1) property or three (3) property exception provided for under Dodd Frank?

Most attorneys are concerned over creating such a scenario in order avoid the application of the Dodd Frank Act and are concerned over the fact that there has been no interpretation over these types of structured transactions. On the other hand, one argument can be that there is free alienability of property under Florida Law. There is nothing in the law that would prevent a corporation, partnership or limited liability company, etc., from electing to transfer its real property to its members who then could convey interest in real estate to third parties using the exceptions under the Dodd Frank Act. This may also be a legitimate decision based upon a corporate/company vote. For example, the necessity to accomplish a 1031 Exchange that one or more members want to do and could only be accomplished if the business entity does a corporate distribution of part of its real estate to title it in the individual names of members or shareholders to accomplish such 1031 Exchange.

5. TWO KEY EXCEPTIONS UNDER DODD FRANK: "ONE PROPERTY EXCEPTION" AND "THREE PROPERTY EXCEPTION".

In the event that a consumer is purchasing residential property for their own use in which the consumer intends to reside, the Dodd Frank Act does provide certain exceptions for Sellers who wish to sell their property and carry back purchase money financing. In the two (2) following exceptions, a Seller providing such purchase money financing will not find his/her/themselves in the definition of "loan originator" if there are certain criteria met.

a. "One Property Exception" ("Natural Person, Estate or Trust Only" – In this situation utilizing the example set forth above, an Owner of a residential unit can extend credit to a Purchaser secured by a mortgage encumbering a prospective residence of the Purchaser and would not be considered a "loan originator" if the following seven (7) points are met:

1. Owner is a "natural person", estate or trust (See discussion above regarding conveyance from an entity into a trust, individual(s) name(s) or estate).

2. Seller provides financing for only one (1) property during any twelve (12) month period.

3. Seller owns the property securing the financing (seems axiomatic since otherwise it wouldn't be considered purchase money financing).

4. The individual did not construct or act as a Contractor for the construction of the residence on the property (See discussion above in which an entity acting as a Contractor simply conveyed the property to its shareholders in proportion to their ownership interest in the company by creating a Florida Trust or tenancy in common arrangement and then those individuals make use of the one (1) exception rule). The same concept would be in effect if an individual, such as a General Contractor, creates a separate entity to convey title to and then that separate entity, which did not construct the property, engages in purchase money financing. Query whether Courts would allow such format to take place notwithstanding the fact that this might be a better approach to undertake between and amongst the members for a number of business tax reasons such as 1031 exchange purpose for certain of the members.

5. Balloon payments are allowed but the exception that address these issues indicate that the recommended balloon period is five (5) years. However, there is an identified two (2) year window in which the balloon may occur. Again, no clear cut case law has been made yet. If a shorter balloon than five (5) years is considered, close scrutiny of the language and the format should be addressed in compliance with the exceptions to the Act.

6. There must be a fixed rate or adjustable rate that resets after five (5) or more years. There are restrictions, limitations and caps on rate changes and lifetime cap of rates.

7. Seller does not have to undertake underwriting requirements to determine the creditworthiness and ability of the Borrower to repay the Loan.

The above seven (7) points are the general exceptions allowing only an individual ("natural person"), trust or estate to provide purchase money financing for one (1) residential unit sold to a consumer who intends to reside in that Unit with such exception to be allowed once during any twelve (12) month period.

b. "Three Property Exception" ("Person" which includes business entities) – There is an allowance for three (3) properties to be sold per year and not fall within the restrictions of the Dodd Frank Act nor cause the Seller to be considered a "loan originator" for purposes of Dodd Frank under the following conditions:

1. 12 CFR Section 1026.2(a) 22 defines a "Person" as a natural person or an organization, including a corporation, partnership, proprietorship, association, cooperative, estate, trust or government unit. So, we now have Federal law confirming what Governor Romney stated in his 2012 campaign "Corporations are people".

2. Seller provides financing for only three (3) properties or less during any twelve (12) month period.

3. Seller owns the property securing the financing.

4. The person did not construct or act as a Contractor for the construction of the residence on the properties (See discussion above regarding conveyance from a contractor to a third-party entity or individual to avoid application of the Act).

5. Financing must be fully amortized which means there must be no balloon payments or structures allowed. Clearly, this creates an issue since most owner financiers do not want to continue to carry mortgage paper for an extended period of time while at the same time Purchasers under these scenarios would like to get the benefit of the longest amortization period (*e.g.,* thirty (30) year amortization), if possible, to reduce the monthly payments.

   In this scenario, the Seller can nonetheless continue to increase the interest rates over the life of the loan. The pragmatic concept is that if the Seller increases the rates to a certain level and the Purchaser is in the home for a period of time to create a good loan payment history and presumably creates equity, wouldn't it be inevitable that the Purchaser would simply refinance to a market rate loan rather than continue to pay higher than

market rate even though that higher than market rate was allowable under Dodd Frank?

For example, a fixed rate loan for five (5) years with increases adjusting annually by one (1%) percentage point. How is a consumer hurt if given the choice to select refinancing to a market interest rate mortgage or to stay with increases rates via purchase money financing?

Under Florida Law, a debt under $500,000.00 would allow interest rates to be increased to a maximum of eighteen percent (18%) per annum. In reviewing some of the cap rates and factors, Dodd Frank imposes some restrictions on annual and lifetime increases. However, the countervailing argument is the question of how does an individual selling with purchase money financing identify with any reasonable certainty what an effective interest rate will be in six (6), seven (7) or ten (10) years from the date of the creation of the debt? Unlike an institutional lender, is a private individual or private seller financier required to predict inflation rates in the future? How will the Court construe whether the increase in interest rates were consistent with the intent of Dodd Frank or whether the Seller was simply trying to protect itself from high rates of inflation and low returns on its investment?

6. Consumer Ability to Repay – Unlike the one (1) property exception which eliminates this obligation, in a three (3) property exception rule, the Seller and provider of purchase money financing must make a determination, in good faith, that the consumer has a reasonable ability to repay. Dodd Frank indicates that while Sellers are not required to provide underwriting criteria that would match what an institutional lender might request. The recommended approach is that Sellers take some steps to identify the ability of the Borrower to repay.

Some authors suggest that this be done by:

A. Identifying the Borrowers current annual income.

B. Identifying debt coverage ratios.

C. Identifying Borrower's current ability to maintain payments for housing and how that matches up with the new obligations of the purchase money financing.

D. Determining if there are any adverse judgments against the Purchaser.

E. Determining the employment status of the Purchaser.

There are no hard and fast rules that have yet been determined by the Court which would identify whether good faith in underwriting a particular loan has

occurred. The creation of some type of Seller financing underwriting criteria and the maintenance of these records seem to be essential in the event any litigation arises under Dodd Frank affecting that particular Purchaser.

One alternative is to consider utilizing a licensed Loan Originator on each transaction. The law states that a "loan originator" is a person who, for or in expectation of direct or indirect compensation or other monetary gain, performs any of the following activities:

1. Takes an application, offer, arranges, assists a consumer in obtaining or applying to obtain, negotiates, or otherwise obtains or makes an extension of credit for another person; or

2. Represents to the public through advertising or other means that such a person can or will perform any of these activities. A "loan originator" includes individuals and organizations, as well as an employee, agent or contractor of the creditor or loan originator organization. A loan originator may include an independent mortgage broker or a bank loan officer.

Loan originators are obligated to follow all rules and regulations of the Dodd Frank Act.

Query whether a private lender using a loan originator as the intermediary can avoid application of Dodd Frank and the requirements set forth therein or whether the actual party making the loan has to be a Loan Originator?

6. PENALTIES ARISING UNDER DODD FRANK: "DRACONIAN"

Dodd Frank and related Federal Acts such as RESPA and Truth in Lending can create significant liability for a Seller utilizing purchase money financing and failing to comply with the restrictions and regulations imposed by Dodd Frank.

Specifically under Dodd Frank, there are penalties identified in 12 U.S. Code § 5565 (a) which include:

(2) "Relief": Relief under the Section may include without limitation:

A. Rescission and Reformation of Contract;
B. Refund of monies or return of real property;
C. Restitution;
D. Disgorgement or compensation for unjust enrichment;
E. Payment of damages or other monetary relief;
F. Public notification regarding the violation including the cost of notification;
G. Limits on the activities and functions of the person; and
H. Civil money penalties as set forth more fully in subsection (C).

Going into Sub-section C, the following are the staggering penalties amounts:

A. First Tier: For any violation of law, rule or final order or condition imposed by writing by the Bureau, a civil penalty may not exceed ***$5,000 for each day*** during which such violation or failure to pay continues.

B. Second Tier: Notwithstanding paragraph (A), for any person that recklessly engages in a violation of a Federal consumer financial law, a civil penalty may not exceed ***$25,000 for each day*** during which such violation continues.

C. Third Tier: Notwithstanding subparagraphs (A) and (B), for any person that knowingly violates a Federal consumer financial law, a civil penalty may not exceed ***$1,000,000 for each day*** during which such violation continues.

Violating Dodd Frank in purchase money financing on the sale of a $100,000.00 home and the Seller, engaging in such financing, is in violation of Dodd Frank could face a penalty equaling a large fraction or, in fact, up to 10 times the amount of the sale itself. The application of Dodd Frank to some of these hybrid formats and the exposure created thereby.

From the standpoint of causes of action, in Florida at least, most legal scholars and this writer believe that a Borrower would be able to seek a number of remedies as set forth in the Act including a rescission of the documentation and a refund of all of its monies. There could also be a request made in Court to reform the financing arrangement. The Borrower could also seek damages, both consequential as well as potentially special damages, which might include return of all of Borrowers costs together with prejudgment interest, a recapture of any monies paid (both principal and interest). The Borrower may seek a number of other causes of action which include violation of Florida's Unfair and Deceptive Trade Practice Act since the conduct could be claimed as egregious in nature since it violated a Federal Law. There could be a claim for unjust enrichment by the Seller as well as, potentially civil conspiracy involving claims regarding an entity and its principals disbursing property to avoid the application of Dodd Frank.

I am certain that almost every attorney who looks into this sees the significant potential exposure and types of claims that could be created by Plaintiff's counsel against the Lender who might run afoul of the Dodd Frank Act.

As such, as indicated previously, caution needs to be taken to identify each and every transaction to determine compliance with the Act.

7. FUTURE ARTICLES AND OTHER ASPECTS OF THE DODD FRANK ACT THAT MAY ALSO IMPACT THE MARKETPLACE: FLIPS, LEASE OPTIONS AND OTHER FORMATTED REAL ESTATE TRANSACTIONS

A number of real estate investors acquire single family homes at a discount in order to resell them: Some take back purchase money financing. No case law has been interpreted but would these individuals who purchased homes to "flip" and who may have done some "work" on the property be considered contractors or builders of the home? I would suggest not but, in fact, what degree of construction would eliminate the individual from being considered a contractor for purposes of Dodd Frank? Does pulling a permit to do repairs make a person a contractor?

Another major area of concern is the Lease with Option and the creation of an equity situation with the Borrower. Clearly, under Florida Law, a Seller can engage in a Lease with Option for residential property. That, in and of itself, statutorily eliminates the lease from the Residential Tenancy Statute under Florida Law since there are parameters that identify why such Lease Option falls outside the scope of the Residential Tenancy Statute (See Florida Statute §83.42 (2). This provision indicates that the Residential Tenancy Statues does not apply to an occupancy under a contract of sale of a dwelling unit or the property of which it is a part in which the buyer has paid at least 12 months' rent or in which the buyer has paid at least 1 month's rent and a deposit of at least 5 percent of the purchase price of the property.

Under these circumstances, would a Lease Option under Florida also fall within the category of being construed under Dodd Frank as a disguised financing approach for the sale of properties and as such Seller Financing?

Again, there is no case law on point construing such arrangement in Florida to the author's knowledge identifying Dodd Frank, specifically; however, the wary Seller should be clearly concerned with such potential exposure.

DISCLAIMER: This Article is not written for legal advice and is published for informational purposes only. The Article is intended to address observations as to certain elements currently in existence with acknowledgement that the Dodd Frank Act has not been interpreted by any significant case law and is subject to current and on-going modifications as to its interpretation. Further, a number of provisions of the Dodd Frank have already been modified. As such, readers are cautioned to this caveat and disclaimer.

Kevin F. Jursinski, B.C.S.
Florida Bar Board Certified Real Estate Law, Business Litigation and Construction Law Attorney
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