Oregon Realtors®: Are Seller-Carried Transactions Safe?

By
Phillip C. Querin, QUERIN LAW, LLC
Website: www.q-law.com

This question is not just rhetorical. As of January 10, 2014, a batch of new laws became effective across the country, including Oregon. Though the laws were intended to deal with Big Bank excesses – you remember, those morally vacuous zombie institutions that singularly brought this country's credit and real estate markets to its knees and ushered in the Great Recession? Yeh, those guys; the ones whose execs never went to jail. Anyway, following Wall Street's near death experience, circa 2008-2009, Chris Dodd and Barney Frank [Big Bank sycophants par excellence] immediately put their low-paid staffers, interns and toadies to work crafting a 900-page bill which has spawned 14,000+ pages in regulations[1]. Like so many politicians before him,[2] Barney Frank apparently didn't read his namesake bill very close either. After creating a law that is more aptly named "FrankenDodd," Mr. Frank, now retired from the House after 30+ pugnacious years berating anyone who disagreed with him, has recently admitted that the law has gone too far. ~PCQ

Background. A "seller-carried" real estate transaction is one in which the buyer does not obtain third-party financing. Instead, the seller carries back a note and trust deed or land sale contract for some or all of the purchase price, and the property serves as the seller's security for repayment.

Subject to the following *caveat*, it is my opinion that despite the handwringing, most sellers and their real estate brokers will likely be able to participate in such transactions with little risk of regulatory liability.

> ***Caveat: Sellers should consult a professional familiar with these types of transactions to learn how, if at all, the Oregon and Federal laws apply. The reason is that Oregon and the federal law both provide that under certain circumstances, offering or negotiating the terms of a seller-carried transaction must be performed by a licensed Mortgage Loan Originator ("MLO"), such as a mortgage broker.***

This was not always the case. In the past, when sellers wanted to sell their primary residence, vacation home or rental, and were willing to provide the financing, the *seller and buyer, either directly or through their respective real estate brokers, negotiated the price, the amount of the earnest money deposit and downpayment, the interest rate due on the remaining balance, the amortization term [e.g. 20, 25, 30 years], and balloon payment, if any. Without trivializing the transaction, the process entailed little more*

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[1] According to a recent Forbes article, Davis-Polk, the highly regarded international law firm that has been closely tracking and reporting on every development of the Dodd-Frank Act, notes that the pages of regulations equate to "… 28 *War and Peace*-length novels, but without the redeeming social value."

[2] **Exhibit A**: Obamacare (aka "The Affordable Care Act") – The law that Nancy Pelosi famously declared that Congress should pass so they could find out what was in it**.** **Exhibit B**: Rep. Maxine Waters (D-Calif.), who, along with Rep. Judy Biggert (R-Ill.), authored the new flood insurance law that was expressly designed to eliminate the huge federal premium subsidies, so that flood insurance ratings would be tied to *actual* risk. Almost immediately after the law was passed and Americans began complaining about their skyrocketing flood insurance premiums, Rep. Waters expressed surprise and amazement, saying that the premium increases were an "unintended consequence" of the law. No Maxine. If you'd have read the law and connected the dots, you would have realized that the law *bearing your name* did exactly what it was intended to do. See my post on "*Water's World of 'Unintended Consequences'*", here*.*

than reaching agreement on these basics and then running an amortization on the balance due. It was generally entry-level Contract Negotiations 101.

> ***Second Caveat: If there is a pre-existing trust deed on the property that will not be paid off at the time of closing, the seller should secure the advice of a real estate attorney to review the lien and draft the transactional documents. The risks must be fully explained to sellers and buyers.***

However, the SAFE Act,[3] Dodd-Frank, and its offspring, the Consumer Finance Protection Bureau ("CFPB"), have collectively cast a wide net. The result has been that the new laws not only cover Big Banks, and regional and small banks, but also *[apparently]* every American selling their own property on a trust deed or contract. How could this be? And why would this be? It was not the Little Guy that nearly brought down the country's financial system and set back residential real estate for five years.

The answer is pathetically simple; with all the legislative activity during the financial crisis, no one was watching out for the Little Guy. Every politician and lobbyist was at the legislative trough on behalf of their favorite and largest contributors, but no one thought about whether the law would impact the average American. A review of the SAFE Act in the Federal Register supports my contention that there was really no intent for individual homeowners selling their property and carrying back paper to be swallowed up in regulatory machinery that was aimed at Big Banks. Rather than correcting this oversight, the federal CFPB and our state regulators, the DCBS[4] and DFCS[5], have seen fit to declare that, subject to limited exceptions, individual sellers of residential properties must be licensed as mortgage loan originators ("MLOs").

<u>What is a MLO</u>? Under Oregon law, a "MLO" is an individual who, for compensation or gain: (a) Takes an application for; or (b) Negotiates the terms of, a residential mortgage loan. MLOs must be licensed by the Oregon Division of Finance and Corporate Securities ("DFCS") and must be registered on the National Mortgage Licensing System ("NMLS"), a database of all persons and companies holding a MLO license.[6]

<u>Can Realtors® act as a MLO</u>? No. But they are exempted from the MLO licensing laws, so long as they limit themselves to "professional real estate activity," as defined in ORS 696.010(14).[7] However, these

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[3] The SAFE Act *["The Secure and Fair Enforcement for Mortgage Licensing Act of 2008"] was* designed to enhance consumer protection and reduce fraud by encouraging states to establish minimum standards for the licensing and registration of state-licensed mortgage loan originators ("MLOs"). The SAFE Act requires that MLOs *[i.e., mortgage bankers or mortgage brokers]* register with the Oregon Department of Consumer and Business Services ("DCBS"). All states have been required to develop their own "SAFE Act." The DCBS has taken the position that Oregon's SAFE Act applies not only to third-party loans, e.g. from lending institutions, but also to seller-carried transactions. Oregon's version of the SAFE Act is found at ORS Chapter 86A.

[4] Department of Consumer and Business Services.

[5] Division of Finance and Corporate Securities.

[6] See, ORS 86A.203(1) and 86A.200(4)(a).

[7] The permitted activity under this statute is very broad: (14) "Professional real estate activity" means any of the following actions, when engaged in for another and for compensation or with the intention or in the expectation or upon the promise of receiving or collecting compensation, by any person who:

(a) Sells, exchanges, purchases, rents or leases real estate;
(b) Offers to sell, exchange, purchase, rent or lease real estate;
(c) Negotiates, offers, attempts or agrees to negotiate the sale, exchange, purchase, rental or leasing of real estate;
(d) Lists, offers, attempts or agrees to list real estate for sale;

services should not include: (a) Taking an application for a residential loan; (b) Offering; or (c) Negotiating the financing terms of a transaction in which the seller is carrying back paper. *[Note: There is a big difference between a real estate broker, acting as a scrivener or scribe, writing up the terms of a transaction as instructed by their client, versus stepping into the shoes of that client to "negotiate" the financial terms of a transaction - as if the broker is the principal. The former activity is permissible, but the latter is not.]*

As they have always done in the past, real estate licensees may provide general financial information to their clients concerning such things as current rates of interest and financial terminology. But they are not experts in all of the state and federal laws, rules, and regulations. Accordingly, sellers and buyers – especially sellers – who are considering engaging in a seller-carried transaction, should secure expert third-party advice *before* offering, advertising, or negotiating any of the financing terms with a buyer. This expert advice may come from a licensed MLO, an attorney, or a financial expert – just not a real estate licensee. The purpose of such a consultation is for the seller to better understand his or her rights, duties and obligations *before* offering or negotiating the financial terms of a seller-carry transaction.

Exemptions to the MLO Law. Fortunately, there are certain exemptions for individual sellers of residential real estate that will cover most garden variety seller-carry transactions, thus eliminating the need to hire a MLO. As noted above, licensed real estate brokers, engaged in "professional real estate activity" as defined in ORS 696.010(14) are exempted from the MLO law – so long as they don't engage in MLO activity, i.e. offering and negotiating financial terms.

Certain sellers of one-to-four family properties are exempted from the Oregon MLO licensing laws. But deciding whether or not to use a MLO is a decision sellers should only make with expert help. Their real estate licensee is not qualified to render advice about whether an applicable exemption applies. In my own opinion, this does *not* mean that a real estate broker may not provide information or direction for sellers who are searching for answers. Good real estate brokers are also information brokers, they just can't *counsel* or *advise* on the scope or application of the MLO exemption laws.

The Federal MLO Exemptions. The federal exemptions cause an unfortunate and complicating level of confusion for seller-carry transactions in Oregon; *but it is unlikely they will apply when individuals sell*

(e) Offers, attempts or agrees to perform or provide a competitive market analysis or letter opinion, to represent a taxpayer under ORS 305.230 or 309.100 or to give an opinion in any administrative or judicial proceeding regarding the value of real estate for taxation, except when the activity is performed by a state certified appraiser or state licensed appraiser;
(f) Auctions, offers, attempts or agrees to auction real estate;
(g) Buys, sells, offers to buy or sell or otherwise deals in options on real estate;
(h) Engages in management of rental real estate;
(i) Purports to be engaged in the business of buying, selling, exchanging, renting or leasing real estate;
(j) Assists or directs in the procuring of prospects, calculated to result in the sale, exchange, leasing or rental of real estate;
(k) Assists or directs in the negotiation or closing of any transaction calculated or intended to result in the sale, exchange, leasing or rental of real estate;
(L) Except as otherwise provided in ORS 696.030 (12), advises, counsels, consults or analyzes in connection with real estate values, sales or dispositions, including dispositions through eminent domain procedures;
(m) Advises, counsels, consults or analyzes in connection with the acquisition or sale of real estate by an entity if the purpose of the entity is investment in real estate; or
(n) Performs real estate marketing activity as described in ORS 696.600.

their own residence, a rental, their second home, a vacation home, or even an occasional rental property. Why? Because the federal MLO exemptions, along with a series of complicated rules concerning the type of financing terms that may be offered, are all found in the Truth in Lending Act, or "TILA." Enacted in 1968, TILA requires certain disclosures regarding the cost of credit and gives consumers certain rights of rescission. Today, it is administered by the CFPB. By its terms TILA, or "Reg Z," its other name, applies to a limited set of transactions which likely will *exclude* their application to basic, garden-variety, seller-carried transactions in Oregon:

- TILA only applies to one who is a "creditor," which means they have engaged in over five mortgage transactions per calendar year. [8]
- It is also limited to transactions with "consumers," which means "…a natural person to whom consumer credit is offered or extended."[9]
- It deals with "residential mortgage transactions" which are defined to mean "…a transaction in which a mortgage, deed of trust, purchase money security interest arising under an installment sales contract, or equivalent consensual security interest is created or retained in the consumer's principal dwelling to finance the acquisition or initial construction of that dwelling.[10]
- It deals with "dwellings" i.e. residential structures "… 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."[11]
- Lastly, TILA deals with "consumer credit transactions," i.e. those in which credit has been offered or extended to a consumer *primarily for personal, family, or household purposes*.[12]

Aggregating these rules together suggests that the following seller-carried transactions *will not likely be subject to TILA, but will likely be subject to Oregon law:*

- When the seller is not a "creditor" under the five/calendar year TILA exemption;
- When the buyer is not a "consumer" because it is not a natural person;
- When the subject property will not become the consumer's primary residence;
- When the subject property will have a non-residential use;
- When the property involves a multi-plex in excess of four units, even if the seller lives in one of them;
- When the credit is being offered for something other than personal, family, or household purposes – in other words, if it is for business purposes, TILA does not apply.

Clearly, not all credit transactions fall into discrete non-TILA pigeon-holes, but for those that do, the next step in the analysis is to see if the transaction complies with one of the Oregon exemptions from the

[8] Section 226.2(17) of Reg. Z provides that a "Creditor" means: (i) A person who regularly extends consumer credit that is subject to a finance charge or is payable by written agreement in more than four installments (not including a down payment)…." *** A person regularly extends consumer credit only if it extended credit (other than credit subject to the requirements of § 226.32) more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. *[Note: The calculation of 5 times per calendar year is subject to additional regulations, so those interested in further inquiry, should carefully review Section 226.2.]*

[9] See, Section 226.2(11) of Reg. Z.

[10] See, Section 226.2(24) of Reg. Z.

[11] See, Section 226.2(19) of Reg. Z.

[12] See, Section 226.2(12) of Reg. Z.

MLO law. If it does, that should be the end of the inquiry; the seller will likely be able to offer and negotiate the terms of his/her seller-carry transaction without having to employ a MLO.

The Oregon MLO Exemptions. Under Oregon law, the following exemptions to the MLO licensing law apply to seller-carry transactions:

- Individuals who offer or negotiate terms of a residential mortgage loan with or on behalf of the individual's spouse, child, sibling, parent, grandparent, grandchild or a relative in a similar relationship with the individual that is created by law, marriage or adoption. *[See,* ORS 86A.203(2)(b)*];*
- Individuals who sell a property that is - or was - their primary residence. *[See,* ORS 86A.203(2)(c)*]*;
- In 2013, House Bill 2856 was enacted, which thankfully added a new exemption:
  - Individuals who sell up to three (3) non-primary residences per year do not have to secure a MLO license;[13]
    - So long as they hold no more than eight (8) residential mortgages at any one time; and,
    - So long as the federal Consumer Financial Protection Bureau does not rule otherwise.

According to the Oregon DCBS, House Bill 2856: "…means that, beginning September 3, 2013, an individual selling investment property or a vacation home does not need a mortgage loan originator license to take an application or negotiate the terms or conditions of a residential mortgage loan that is secured by the property."

But don't confuse the TILA exemptions with the Oregon MLO exemptions! While the TILA exemptions look too see if the purpose of the loan is for *residential use – e.g. the borrower is acquiring the property to live in*, the Oregon exemptions do not. In other words, if the buyer intends to use the property as a rental, the Oregon MLO law, with its exemptions, will apply.

Final Thought. *Simpler is safer.* If one's seller-carried transaction contains certain features such as pre-payment penalties, adjustable interest rates, or high interest rates, it will be subject to more rules and regulations which could require the use of a MLO. This is especially true of "High-Cost Mortgages." Whether a seller-carry transaction is a High-Cost Mortgage is beyond the scope of this article. It is determined by several factors, although the primary one is whether the transaction's annual percentage rate ("APR") exceeds the Average Prime Offer Rate ("APOR") by more than 6.50%. The APOR is an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for low-risk mortgage transactions, i.e. prime loans. The APOR is published at http://www.ffiec.gov/ratespread. Such transactions that qualify as High-Cost Mortgages require that the seller must give additional disclosures, avoid certain loan terms, and ensure that the buyer-borrower receives additional protections, including homeownership counseling. If a seller believes their transaction may qualify as High-Cost Mortgage, he or she should consult expert professional assistance **before** offering or negotiating those terms. Again, a real estate licensee is not qualified to advise on these matters.

Conclusion. It is unfortunate that Dodd-Frank, and its progeny, have opened a Pandora's Box of regulations that have infected the entire strata of residential transactions all the way down to individual seller-carried financing transactions. It's one thing to hang this albatross around the collective necks of

[13] Note: A vacation or second home is a "non-primary residence."

the Big Banks that caused Wall Street's near death experience – but it's quite another to strike fear into Moms and Pops selling their homes or occasional rental properties.

In my opinion, there is not a single, responsible, self-respecting regulator who can say, in a good faith and intellectually honest moment of self-reflection *[assuming there are such regulators and they have such moments]*, that this morass of laws should ever have been applied against the Little Guy. I guess that's why regulators regulate, since they've never had to compete in a free capitalistic society. Those that *can*, do, and those that *can't*, regulate the others….