<u>Mechanics of a Purchase:</u> <u>**Where the Money Comes From and How**</u>

Outside of a cash purchase, there are basically two main modes of financing available to us:

1. Owner (Seller) Financing
2. Third Party Financing

There are a number of options as to how third party financing could be handled, both in terms of where the money can come from and the paperwork involved. I will address these later in the chapter. First, let's focus on owner-financing.

1. Owner Financing

<u>Why Owner Financing</u>

Very simply put, owner-financing represents the greatest opportunity in the world for financing of real estate. First of all, it is simply easier to deal with the seller than to deal with the bank. You've probably heard it said that dealing with the banks is *their way or the highway*, and it is. You are much more likely to negotiate better terms by far when dealing with the seller. In fact, <u>all</u> of the terms are negotiable when dealing with the seller!

Secondly, for those of us who are not able to qualify for a bank loan, owner-financing represents the only entry point into the game. This in and of itself places owner-financing above all other modes of financing.

And finally, owner financing keeps things simple. As an investor putting together a deal, it is always preferable to me that as few people are involved as possible. Often times it cannot be helped that I have to deal with a number of different lenders in the course of one transaction, but given the choice I would always prefer to deal with one - the seller. This saves time and closing costs, lessens the down-payment requirements, and avoids the need for private investment capital, which comes at a premium.

<u>Land Contract (Contract for Deed)</u>

There are several ways to accomplish owner-financing, of which Land Contract is most commonly used. Land Contract is essentially an installment sale agreement. It is a valid sale which vests the buyer with *Equitable Title* to the property, and outlines the terms under which the buyer can attain the *Legal Title*.

Among the terms outlined in a land contract include the purchase price, down-payment, interest rate, monthly payments amount, and the time-frame. Typically, a land contract incorporates a balloon payment, so that having made payments for a period of time the buyer must fully cash-out the seller, which most often involves some sort of a refinance.

Under a land contract, the deed to the property, and therefore the *Legal Title*, remains with the seller until all of the terms stipulated in the contract have been met by the buyer, at which time the deed and therefore the *Legal Title* is transferred to the buyer.

It may be useful to know that, as it relates residential property, after the buyer achieves the thresh hold of 20% equity or 60 monthly payments (at least in the State of Ohio), the buyer cannot lose his equity and a foreclosure process is required for the seller to repossess the property. Having said this, in a land contract the buyer is ultimately not the owner of the property until and unless all of the stipulations set forth in the contract have been met. In this way, the buyer's interest in the property is somewhat less protected than we'd like, even after the thresholds have been achieved. In my opinion, this makes land contract the best of bad choices relative to vehicles by which to accomplish owner financing, at least from the buyer's perspective.

A typical scenario could be the following:

Martha agrees to sell Dave her house for $60,000. She requires $2,000 down, and monthly payments of $500, which includes 6% interest. She gives him 5 years to exercise the contract and cash her out.

In order to pay Martha off, Dave can either secure bank financing for the remaining balance of what he owes in 5 years, or, unless it is specifically prohibited in the contract, Dave can simply additional payments toward the principal as he goes to amortize the loan to $0.

Benefits of Land Contract to a Buyer

1. The biggest benefit of a land contract is that it can make purchase attainable to someone who is not financeable at the bank since there are no uniform qualifying standards.

2. Another benefit is that all of the terms are negotiable. It is definitely possible to negotiate better terms than what is available at the bank, including a lower interest rate and a smaller down-payment.

Draw-backs of Land Contract to a Buyer

1. Since the buyer does not gain legal title until the contract is fulfilled, if something happens which prevents the buyer from being able to fully perform under the contract, he will potentially loose everything that he put-in. Even after the thresh hold is achieved; the attorneys will have a field day…

2. From an investor's point of view the previous point creates a problem with respect to upkeep and remodeling, because the investor would be putting money into a property that he ultimately does not own and could lose.

This is why land contract is not my favorite vehicle for executing owner-financing as a buyer, although the Wendell House transaction that I described earlier was a land contract.

A word of caution: specifically because your interest in the property (as a buyer) is not as well protected with a land contract as we would like, it is crucially important to utilize the help of a good real estate attorney.

Benefits of Land Contract to a Seller

If you happen to be on the other side of the equation, the main benefit of utilizing a land contract to sell property is that you, as the seller, can determine the qualification requirements, which means that you are not bound by the qualification standards of bank financing. Therefore, especially in a bad economy, a land contract can be a valuable tool to enable you to get out from underneath a property.

An example of this could be a flip that you began, but by the time you were ready to bring the property to the market the conditions had changed making it difficult to sell the property outright to the end user. A land contract might get you out of a bind in this case.

Drawbacks of Land Contract to a Seller

The problem with a land contract as a sales tool is that it constitutes a legal sale which conveys upon the buyer equitable interest in the property. As such the foreclosure is the only remedy for a land contract gone badly, unless the buyer walks away. In other words, if you have someone in your property who has not abided by the stipulations of the contract, you may need to sue. This takes time, costs money, and causes aggravation. Furthermore, since a lot of the money you receive from the buyer (specifically those funds that are applied toward the principal) can and probably will be qualified as earnest money, by law you may have to give it back if the buyer walks away. As such, many investors looking to sell property on contract will utilize a *Lease Option* or a *Lease Purchase* in lieu of a land contract.

Lease Option

A lease option is simply understood as a lease, with an option to purchase. The tenant secures the option with an *option consideration*, which is most often a one-time non-refundable payment. The option clause outlines the terms under which the property may be purchased.

This is different from a land contract because the basis of this agreement is not a sale; it is a lease. This makes it possible to achieve the same desired effect of allowing someone to gain possession and to have the option of buying the property, but makes it much easier to dissolve the relationship in case the tenant does not perform as per the agreement. All that is required is an eviction, which is a much easier pill to swallow. Furthermore, since the option consideration is usually non-refundable, if the option is not exercised as per the terms of the contract the tenant/buyer loses this money. As such, a lease option can be much more preferable to land contract as a sales tool – there are fewer "gray areas".

As a buyer, however, the same concern exists to an even greater degree in that your interest is highly unprotected. In fact, whereas the land contract transfers upon the buyer the equitable interest, a lease option does not. An option is not a sale, and as such no rights inherent in a sale transfer with an option. Thus, as a buying tool lease option offers very little protection.

Lease Purchase

A little better deal than a lease option is a lease purchase. Lease purchase is executed with two contracts, namely a lease and a sales agreement. Because the actual sale is delayed until such time as the buyer performs according to the terms, a lease purchase does not transfer equitable interest, making it undesirable to the buyer. However, the seller in a lease purchase often agrees to attribute a portion of the rental payments toward the principal balance, which is tallied-up and applied against the purchase price at the time the tenant completes the purchase and becomes the buyer.

Purchase Money Mortgage

In my opinion, a purchase money mortgage is the best vehicle with which to accomplish owner financing, at least from a buyer's perspective. What is important to understand is that in the State Ohio, which is a lien theory state, a purchase money mortgage transfers the deed, and therefore the legal title to the buyer, which affords much higher level of protection of the buyer's interest and ownership rights in the property than a land contract or any other method of owner financing. In fact, possession of the title offers the highest degree of protection of ownership rights that exists - period. And with this, I am venturing into the arena of real estate collateralization.

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