Purchase Money Financing: Not Just for Homeowners

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08.03.2022

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In recent years, many property owners have refinanced their mortgages to take advantage of low interest rates. When interest rates rise, buyers may prefer to assume a seller's existing loan since new loans have higher interest rates and require significant closing costs. However, a buyer can't always come up with the remainder of the purchase price in cash. This is often the case if the seller's loan has been paid down or the property's value has risen and created a significant amount of equity in the property.

The buyer may then propose that a seller take back a purchase money mortgage for the portion of the seller's equity that the buyer can't pay in cash. While this scenario is more common in residential transactions, it can also apply in commercial transactions.

If you are a seller who agrees to take back a mortgage on the sale of your property, it's important to understand that your mortgage will be junior to any existing first mortgage that is not paid off at closing. Should the buyer default on the first mortgage, your second mortgage can be foreclosed and extinguished. If the property doesn't yield enough money at the foreclosure sale to pay you off, you could end up losing that portion of your equity.

To help minimize your risks in taking back a purchase money mortgage, there are several factors to consider when structuring the deal.

- Make sure the buyer has good credit and can afford to make all mortgage payments.
- Ensure that the buyer pays enough cash at closing so that they have some equity of their own in the property. A buyer who finances the entire purchase price frequently has no incentive to keep up the property or continue to make payments if they experience financial difficulties.
- Once you're comfortable with the buyer and the amount of the new mortgage, make sure your existing mortgage isn't due on sale and doesn't prohibit second mortgages. If that's a problem, you will need to get the lender's consent.

- See if your lender will agree to release you from liability at the sale. Many first mortgages allow this if the buyer qualifies to assume the loan. Without a release, the lender can still hold you liable after you sell your property if the buyer doesn't make the first mortgage payments. This may affect your ability to qualify for financing if you're going to buy another property.
- Make sure the sales contract is conditioned on the lender giving any necessary consent and agreeing to release you if the buyer qualifies to assume the loan. If the buyer can't qualify, you should reserve the right to terminate the contract.
- Consider what type of interest rate and payment schedule is appropriate. You may allow payments of interest only for a stipulated period (with a balloon payment at the end), or you may wish to amortize payments so that the buyer is paying down some principal each month. The latter is the better option if the buyer can afford it.

The sales contract should specify the exact payment terms and include some detail regarding other terms of the note and mortgage you're taking back. It should also require the buyer to pay recording fees and taxes on the mortgage, as well as the premium for a mortgagee title insurance policy.

The mortgage itself should provide that any default by the buyer under the first mortgage will also be a default under your mortgage. It should give you the right to cure those defaults to protect your interest in the property, with any expenses you incur being added to the amount you're owed.

The mortgage should also require you to be named as a beneficiary of the buyer's casualty insurance policy, and it would be a good idea to require liability insurance as well. It should have a due on sale clause, as well as a clause prohibiting any other mortgages; otherwise, the buyer may sell the property to someone else who won't keep up your payments, or the buyer may pull their equity out of the property by getting another mortgage.

Most real estate brokers and office supply stores don't have comprehensive forms of purchase money notes and mortgages available. Since you may be financing a significant portion of your equity, you should have a lawyer help you draft the sales contract, as well as the purchase money note and mortgage, to address these concerns. Once you've signed the contract, it may be too late.