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WRAPAROUND TRANSACTIONS IN TEXAS

What is a wraparound transaction?

A wraparound transaction or a "wrap" is a form of seller-financing that leaves the original loan and lien on the property in place when the property is sold. The buyer makes a down payment and signs a new note to the seller (the "wrap note") for the balance of the sales price. This wrap note, secured by a wraparound deed of trust, becomes a junior lien on the property. The buyer makes monthly payments to the seller on the wrap note and the seller in turn makes payments to the original lender.

In the usual case, the wrap note to the seller exceeds the amount of the underlying loan payoff by the amount of the seller's equity. The interest rate may also be higher. The wrap note is usually amortized over 15 or 30 years but balloons in 3 to 5 years (ie., the buyer has that 3 to 5 year period in which to refinance and pay off the wrap note). Specific terms can vary from transaction to transaction, but the wrap principle remains the same. Terms of the wrap itself should be contained in a wraparound agreement that thoroughly deals with details of the transaction.

When the buyer refinances, the original loan is released and the seller keeps any cash that exceeds the payoff amount of the first lien. The main difference between a wrap and a conventional sale is that the seller must wait until the wrap note balloons in order to receive the full sales proceeds in cash.

Wraparound financing is sometimes referred to as subordinate lien financing.

How is that different from a contract for deed?

A wraparound is an "executed" transaction as opposed to an "executory" (ie., incomplete) transaction. The buyer gets a deed to the property immediately, not at some future time. His indebtedness to the seller is secured by a deed of trust. Therefore, the burdensome rules applicable to executory contracts (contracts for deed, lease-options, and the like) do not apply.

Isn't a wrap the same thing as an assumption?

No. In an assumption, the buyer directly assumes responsibility for paying the existing note. Sometimes this is done with the approval of the seller's lender, sometimes not; but the assumption documents expressly state that the buyer is taking on the legal obligation of paying the assumed note. In a wrap, the existing note remains the sole obligation of the seller, and a new note from buyer to seller is created. The buyer is instead obligated to the seller on the wrap note.

Note that in both cases the seller remains obligated on the existing note until it is paid and released.

How can I be sure a wrap is legitimate?

Wrap transactions are legitimate, primarily, because there is nothing that says they are not. There are numerous Texas cases in which wraparound transactions have been upheld. The State Bar of Texas, in its Real Estate Manual, even publishes suggested forms for wrap documents, although use of these forms is not recommended because of their very basic nature.

What if there is more than one existing lien?

It is not uncommon to wrap more than one note and lien (eg., a first and second lien). The prior liens may even be to different lenders. The lien securing the wrap note is then subordinate to the prior liens.

Can you give an example of a wrap?

Consider the example of 123 Oak Street which has a market value of $100,000 but has been slow to move. There is a first lien in the amount of $50,000 to Apple Bank and a second lien in the amount of $25,000 to Orange Bank resulting in $25,000 equity. In the usual case, a purchaser should be able to make a down payment and obtain third-party institutional financing so that the seller receives $25,000 at closing and goes merrily on his way. But what if the buyer is unable to get traditional financing? The solution is a seller-financed wrap note that may be in a premium amount, say $110,000, which is subordinate to the notes due Apple and Orange Banks. As is customary with owner financing, the wraparound note will bear a higher than market rate of interest. It is secured by a wraparound deed of trust that enables the seller to conduct a traditional foreclosure if the buyer defaults on the wraparound note.

Is this a device to get sub-prime buyers into homes?

Not really. The buyer should have a substantial down payment. The seller should evaluate and approve the buyer's qualifications, just as any other lender would. The wraparound is a device to sell property to reasonably qualified buyers who have money to put down and can afford the monthly payments. For less qualified buyers, a land trust may be the better option (Go to the Articles button and read "Land Trusts in Texas").

Can wraps be used in conjunction with land trusts?

Yes. There may be circumstances where it may be a good idea to first transfer the property into a land trust and then do a wrap.

Are wraps just for homes?

No. Both residential and commercial wraps are possible. Commercial liens are more likely, however, to contain provisions that may prohibit a wrap. In commercial cases, one must carefully review the deed of trust securing the existing lien before proceeding with a wrap.

Why would a seller do a wrap?

The seller can unload property *at full market price* - property which would otherwise have to be discounted or be slow to move because buyers are finding it difficult to get traditional financing. The seller gets some cash today (the buyer's down payment) and is then out from under the payments. The seller also gets the benefit of any spread between the interest rate on the wrapped note and wrap note.

Why would a buyer do a wrap?

That is an easy question. The buyer does not have to apply and qualify for a new loan. The buyer gets a warranty deed to the property and immediate possession, without lengthy delays, expensive loan fees, and closing costs.

Why would a broker encourage a wrap transaction?

Aside from meeting objectives of the broker's client, the buyer's down payment supplies cash for the broker's commission to be fully paid at closing, just as with any other transaction.

Is title insurance available?

Yes. A wrap does not interfere with the insurability of title in the name of the buyer, therefore owners title insurance is available, although some title companies may be more inclined to handle wrap transactions than others. A wraparound lien is a valid lien, therefore a mortgagee's policy is available. If a title company is issuing insurance, then closing will be held at the title company. However, many if not most wraps are closed without title insurance, on the basis of a title report or commitment, in a lawyer's office.

Isn't a wrap illegal? Isn't it a breach of contract with the lender? What about the due-on-sale clause?

A wrap transaction is neither illegal nor a breach of contract; nor does it "violate" the due-on-sale clause. If you look carefully at the typical lender's documents, you will see that they usually do *not* prohibit a transfer of property without the lender's consent. They generally state that if the borrower transfers the property without the lender's permission then the lender may, *if it so chooses*, declare the loan due. Look at paragraph 18 of the Fannie Mae/Freddie Mac Uniform Deed of Trust:

> **If all or any part of the Property or any interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument.**

This is not prohibitory language. It says the lender *may* accelerate the note if it wants to. When an investor transfers the property without consent from the lender, the investor makes it

possible for the lender, if the lender so chooses, to accelerate. It is not a breach of the deed of trust. It is not fraud. As attorney Bill Bronchick puts it, "There is no due on sale jail."

How often does a lender declare an otherwise performing loan due? They may not like the fact that the property has been sold to someone else, but - so long as payments continue on a timely basis - the risk that a lender will do anything about it is small.

Isn't there some kind of notice requirement before doing a wrap transaction?

Yes. Property Code Sec. 5.016 (effective January 1, 2008) requires (1) 7 days notice to the buyer before closing that an existing loan is and remains in place; (2) giving the buyer this same 7 day period in which to rescind the contract to purchase; and (3) also that the 7 day notice be sent to the lender. These notices are the obligation of the seller and must be in the form prescribed by the statute. Actual lender consent, however, is *not* required. These notices, sent to the loan servicer, generally produce no response.

Note, however, that Property Code Sec. 5.016(c)10 provides an exception "where the purchaser obtains a title insurance policy insuring the transfer of title to the real property."

What if both notes are due on the first of the month?

The timing of payments is an issue, and it should be addressed in the wraparound agreement. It is a good idea to schedule payments on the wrap note 7 to 10 days before payments are due on the wrapped note, so as to allow time for the seller to collect payments from the buyer and forward them on to the wrapped lender.

What about casualty insurance on the property?

The wrapped lender usually collects an escrow for taxes and insurance. It is best to leave the existing casualty insurance policy unchanged and in place. Amending it will result in the wrapped lender being notified by the insurer that title to the property has been transferred. This may generate a letter from the wrapped lender inquiring as to the status of title. The buyer should procure his own contents insurance.

If there is no escrow being collected by the wrapped lender, then the wrap note should provide for one to be collected from the buyer.

Insurance issues should be thoroughly addressed in the wraparound agreement.

What if the buyer defaults on the wrap note?

The seller receives a wraparound deed of trust that enables the seller to foreclose if the buyer defaults in paying the wrap note. He can also seek and obtain a deficiency judgment if the

sales price at foreclosure is insufficient to discharge the wrap note plus accrued interest and fees. The seller thus has the same ability to enforce his note and lien as does any other lender.

Texas is fortunate to have an expedited non-judicial foreclosure process. Property Code Sec. 51.002 requires that a homeowner be given at least a 20 day notice of default and intent to accelerate the note if the default is not timely cured (most attorneys give 30 days notice). This notice must be followed by a second letter stating that since the default was not cured, the note is accelerated and the property is being posted for foreclosure. This second notice must be given at least 21 days before the first Tuesday of the month in which the foreclosure will be held. So, a Texas foreclosure takes a minimum of 41 days (although one should avoid cutting it that close). The advantage for the foreclosing party is that there are no effective defenses to this process except to block it with a temporary restraining order. For that, the buyer needs money and an attorney. They usually have neither.

After foreclosure, the former buyer may still refuse to leave, making an eviction ("forcible detainer") necessary. In order to accomplish this, the owner must give a 3 day notice to vacate, file a forcible detainer petition in justice court, get it served, get it heard by the Justice of the Peace, and then wait 5 days for a final judgment and a writ of possession. One must then wait until the constable posts a 48 hour notice on the door and then forcibly removes tenants who are otherwise unwilling to leave. Elapsed time? At least 3 weeks.

What if the seller defaults by not paying the wrapped lender?

The wraparound agreement provides that if the seller fails to make payments to the wrapped lender the buyer may do so and receive credit against the wrap note.

Is there lots of difficult paperwork?

A properly drafted wraparound transaction will include a warranty deed, a wraparound deed of trust, a wrap note, and a wraparound agreement to address the details. Only a qualified and experienced real estate attorney experienced in preparing wrap documents should be used to draft these papers. There are no "forms" available from any source, including the Texas State Bar, that are adequate to the task. Also, because there is no TREC or TAR standard wrap addendum, the earnest money contract should include an attorney-prepared wrap addendum along with the seller financing addendum.

What are the disadvantages of a wrap?

Obviously, the seller has to wait 3 to 5 years to receive the full proceeds of the sale (The seller needs to weigh this against the fact that today's sale is at full market value, not a discount). Also, the wrapped loan is frozen in place and cannot be refinanced for the duration of the wrap. The seller has to collect and remit payments, which requires his ongoing involvement. If the wraparound borrower defaults, the seller must foreclose, which is not usually a problem with

Texas' expedited non-judicial foreclosure laws. In the unlikely event a loan is accelerated, the buyer may have to secure traditional financing.

What about cost?

Our office charges $750 for residential wraps, $950 plus for commercial, not including recording fees. Closing in our conference room is complementary. There are none of the usual title company charges, but *a la carte* items such as a title report are extra.

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