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TEXAS LAND TRUSTS

Introduction

There are many kind of trusts and most of them can be adapted to hold real estate as an asset (ie., as part of the "trust estate"). The difference revolves around the trust's purpose. Is the creator of the trust (the "trustor" or "grantor") intending to design an estate planning device to avoid probate and reduce estate/inheritance taxes at the time of his or her death (often called a "living trust")? Is the trust being created for anonymity purposes as part of an asset protection plan? Or does the trustor want to acquire or dispose of investment real estate? Perhaps the trustor wishes to achieve a combination of these objectives.

Clients often call and ask for a "standard" trust - or worse, a fill-in-the-blank form - neither of which exists at any acceptable level of quality. There is no substitute for the analysis and advice of a competent professional in this complex area of the law. The challenge for the attorney is to discover what the client is trying to achieve and then tailor a document to suit specific needs. Note that maximum asset protection is achieved when a land trust is used in combination with a limited liability company.

Suggested reading includes two companion articles on this site, "LLC Formation in Texas" and "Asset Protection in Texas."

The Living Trust

The living trust is a tried and true means of avoiding probate court and, if the trustor is married, skipping a taxable event upon the death of his or her spouse. This author considers living trusts to be an excellent way to achieve a variety of positive results. A living trust should at least be considered as part any middle-class estate plan. It is critical, however, that such trusts be properly drafted so as not to restrict the trustor's access to and use of trust assets during the trustor's lifetime. Among other things, this means granting no powers or direction or appointment to the beneficiaries - a common mistake that can cause litigation. All power and authority should remain with the trustor, who also serves as trustee.

The trustor also reserves the right to revoke or amend the trust. The terms of the trust are therefore not finally fixed until the trustor dies, at which time the other beneficiaries

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automatically succeed to the trustor's interest. No deed or probate is required.

The Anonymity Trust

The anonymity trust is usually established as part of a broader asset protection plan. It is a relatively simple document that is executed along with a warranty deed conveying real property into the trust. The deed lists the trust as the new owner (the "grantee") without naming the trustee, and it gives a post office box as the address of record

Since trusts are not legal entities (in the same sense that an LLC is, for example) there is no liability barrier against lawsuits as is the case with a corporation or limited liability company. However, creation of a trust to hold title to property can provide anonymity of ownership since the true owner's name need not be revealed on the deed and trust information is not recorded or on file at any public office. The optimum scenario is this: the property is transferred out of the individual investor's name and into the investor's LLC, which in turn deeds the property into a land trust.

This combination can present significant hurdles to a plaintiff who wishes to find and sue the property owner. It is even more effective if the investor also sets up a separate Texas LLC to be a management company that deals with tenants and the public (ie., the name of the ownership LLC and the trust are never revealed). The management company is a pass-through entity that collects and disburses funds. At any given moment is essentially an empty shell with no significant assets.

The Role of the Title Company

Note that when the property is sold, the title company will probably want to see the trust agreement. Once again, it is important that the trust be properly drafted so the title company will accept it as valid. This is a crucial point for investor trusts as well (see below). Otherwise, the title company will likely ignore the trust altogether and require signatures from all persons having an actual or potential interest in the property or, in the alternative, a judicial determination of heirship – either of which can defeat the purpose of creating the trust in the first place.

Actually, it is astonishing how many title companies are ignorant of basic trust law and practice. It is occasionally necessary for the trustor's attorney to discuss the trust with the title company closer or attorney in order to educate him or her as to the nature and effect of the trust. This is another powerful reason to have a knowledgeable attorney working on your behalf. No internet service will do this.

Investor Trusts

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We will go into detail here, since these are very popular. There are two basic types of land trusts used by real estate investors: (1) an "entry trust" (my term) used as a tool to acquire and then transfer real estate by means of an assignment of beneficial interest (the "Illinois Land Trust"); and (2) an "exit trust" (my term again) designed to hold title to real estate while a credit-impaired buyer does credit repair until able to obtain a loan to take the property out of trust.

Not all land trusts are created equal. There are a myriad of trusts available on the internet that purport to be good in all fifty states. This is a false claim. This author has never seen an internet land trust that is both valid *and* prudent for use in Texas. A principal defect of trusts marketed over the internet is failure to consider or comply with Texas Property Code provisions pertaining to lease-options. Some attempt to create liens that are unenforceable in Texas. Few of them consider using an LLC in tandem with the trust, an essential element in achieving asset protection. All of them generate complicated transactional documentation with Afill-in-the-blank@ forms, a sure indicator that they are junk. The place to get a valid Texas land trust is from an experienced Texas real estate lawyer who knows what he is doing in this area.

The Entry Trust (Transfer to a Trust Followed by an Assignment of Beneficial Interest)

In this case, an investor coaxes a distressed seller into transferring property by recorded deed into a trust, after which the seller then executes an unrecorded assignment of beneficial interest to the investor. This is usually done in anticipation of a foreclosure. However, these trusts do not delay or stop foreclosure unless the investor is willing to reinstate the loan and continue to make payments until the property is sold.

Drafting the trust is critical. Certain types of these trusts also allow the original seller to retain a beneficial interest (always a bad idea) that allows the original seller to a share of the profits when the property is flipped. Others permit the original seller to have a "power of direction" over the trustee – an even worse idea.

A significant risk, from the investor=s point of view, is that the original seller may still be able to transfer the property to someone else, in defiance of the unrecorded assignment of beneficial interest that has been given to the investor. For this reason, depending on the circumstances, a Asubject to@ deed may be a simpler and better solution than an entry trust. If asset protection is important, then the grantee on the subject to deed should be the investor's LLC.

The Exit Trust (Transfer to a Trust Pending Credit Repair by a Buyer)

In this case, the trustor/investor is the seller. Property is conveyed into a land trust that acts as a temporary Aparking place@ for the property while a credit-impaired buyer (a trust beneficiary) takes immediate possession and works to obtain conventional financing in order to purchase the property outright at a specified price. Sound similar to a lease-option? It is, except

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that beneficial interests in a trust are personal property, not real property, and therefore do not fall under the lease-option provisions of the Property Code.

Ideally, the trustor/investor first conveys the property into an LLC, which is the entity designated by the investor as being the "ownership entity" in his or her asset protection plan. This is followed by a transfer from the LLC into the trust. Including the LLC into this structure adds significant asset protection since a trust alone has no effective liability barrier. Creation of the trust is a private transaction except for the recording of a general warranty deed into the trust. In order to achieve maximum anonymity, the name of the trust should not include the names of any parties to the trust. A good choice for the name is the street address of the property.

At closing, the trustee conveys all powers to an Attorney-in-Fact/Managing Agent which should be an LLC designated by the investor as the management company for his properties. The management company then conducts day-to-day operations, including all dealings with tenants and the public. It is a good idea for the management company to do business under a "dba" – an assumed name.

Structurally, the exit trust works like this: the trust names a minority (10%) beneficiary, who is the trustor/investor/seller; and a majority (90%) beneficiary (the ultimate buyer) who receives the trust's consent to occupy the property and who acquires an option to purchase the minority beneficiary=s 10% interest at a fixed option price. The option is exercisable within a specified term so long as the majority beneficiary is not in default on monthly payments.

The trust agreement is the core document that sets forth the duties and obligations of the parties. It is a detailed and sophisticated document that has evolved as a result of creating over a hundred land trusts and undergoing judicial scrutiny on numerous occasions. Even with all the information in this article, it cannot be duplicated by a beginner.

There is no deed, recorded or unrecorded, into the name of the "buyer," since he or she is *not* purchasing the property at the time the trust is created. The only deed being executed is the deed into the trust.

Comments on Due-on-Sale Clauses

It is widely advertised that land trusts legally prevent a lender from exercising a due-on-sale clause. Is this true? No, it is not, although acceleration may be much less likely. The explanation for this is somewhat technical.

What exactly is a due-on-sale clause? A due-on-sale clause enables a lender, *at its election*, to accelerate a note in the event the property or any interest in the property is sold or transferred. If the contemplated transaction involves a title transfer without prior consent of a lender that holds a note and lien on the property, then the risk of acceleration is present if the

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lender=s deed of trust contains a due-on-sale clause and the lender=s prior consent is not obtained.

Note that there is no such thing as Abreaching@ or Aviolating@ a due-on-sale clause. This is an enabling clause that gives the lender the option of acceleration if the lender chooses to do so.

The most common wording of a due-on-sale clause is found in paragraph 18 of the Fannie Mae/Freddie Mac Uniform Deed of Trust:

> **18. Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, AInterest in the Property@ means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the <u>intent</u> of which is the transfer of title by Borrower at a future date to a purchaser.**
>
> **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. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.**

What is Aapplicable law?@ The relevant statute is the Garn-St. Germain Depository Institutions Act (U.S.C. Title 12, Chapter 13, Sec. 1701j-(d) reads:

> **. . . a lender may not exercise its option [to accelerate the note] pursuant to a due-on-sale clause upon . . . (8) a transfer into an inter vivos trust in which the borrower is and <u>remains a beneficiary and which does not relate to a transfer of rights of occupancy</u> in the property.**

This is the federal living trust exception, which was intended to create an exception to enforcement of due-on-sale clauses in connection with transfers of property to family trusts designed to avoid probate. It was not, however, designed to provide a safe haven for investors.

The truth is that a land trust does not defeat due-on-sale because the transaction contemplates a transfer of rights of occupancy - so due-on-sale provisions remain effective and enforceable. This interpretation is reinforced by FDIC regulations found at 12 C.F.R. 591.5(b)(vi):

> **8000-FDIC Miscellaneous Statutes and Regulations**
> **PART591CPREEMPTION OF STATE DUE-ON-SALE LAWS**
>
> **' 591.5 Limitation on exercise of due-on-sale clauses.**
> **(a) *General.* Except as provided in ' ' 591.4(c) and (d)(4) of this part, due-on-sale practices of Federal savings associations and other lenders shall be governed exclusively by the Office's regulations, in preemption of and without regard to any limitations imposed by**

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state law on either their inclusion or exercise including, without limitation, state law prohibitions against restraints on alienation, prohibitions against penalties and forfeitures, equitable restrictions and state law dealing with equitable transfers.

(b) *Specific limitations.* With respect to any loan on the security of a home occupied or to be occupied by the borrower,

(1) A lender shall not (except with regard to a reverse mortgage) exercise its option pursuant to a due-on-sale clause upon:

(i) The creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property: *Provided,* That such lien or encumbrance is not created pursuant to a contract for deed;

(ii) The creation of a purchase-money security interest for household appliances;

(iii) A transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;

(iv) The granting of a leasehold interest which has a term of three years or less and which does not contain an option to purchase (that is, either a lease of more than three years or a lease with an option to purchase will allow the exercise of a due-on-sale clause);

(v) A transfer, in which the transferee is a person who occupies or will occupy the property, which is:

(A) A transfer to a relative resulting from the death of the borrower;

(B) A transfer where the spouse or child(ren) becomes an owner of the property; or

(C) A transfer resulting from a decree of dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement by which the spouse becomes an owner of the property; or

(vi) A transfer into an inter vivos trust in which the borrower is and remains the beneficiary and occupant of the property, unless, as a condition precedent to such transfer, the borrower refuses to provide the lender with reasonable means acceptable to the lender by which the lender will be assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy.

Any trust created for the purpose of falling within the federal living trust exception must meet these stated criteria. Accordingly, the federal exception to lender enforcement of due-on-sale clauses is limited to properties that are owner-occupied. If the owner moves out and someone else takes occupancy, the loan *can* be called. It is a small but present risk.

For the present, however, this may not matter. Lenders are not generally inclined to accelerate otherwise performing loans, even if a lender knows that the property has been transferred. They are not in the business of foreclosing and owning property. One occasionally sees a letter from a lender threatening acceleration and foreclosure if a new owner does not formally apply to assume the existing loan, but it is generally not in the lender's best interest to follow through on this.

Seven-Day Notice Requirement

The seven-day notice requirement was passed in 2007 as HB 2207, now Property Code Sec. 5.016. It is a peculiar law in many respects. When a property transfer does not result in paying off the lienholder(s), the following is required: (1) the seller must give 7 days notice to the buyer *before* closing that an existing loan is in place; (2) the buyer is allowed this same 7 day

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period in which to rescind the contract to purchase; and (3) the 7 day notice must also be sent to the lender, theoretically giving the lender an opportunity to accelerate and call its note due. Actual lender *consent*, however, is not required. It is unclear if lenders will now use this notice as a basis for declaring loans due. So far, it is not happening.

Some investors use the strategy of sending the notice to the servicing agent's payment address, which is not typically set up to receive correspondence. The notice then gets lost in the shuffle.

If the notice is not given, the buyer can back out of the transaction before closing. Otherwise, there is no penalty for not complying with Sec. 5.016. Caution, however: The mortgage loan fraud law passed in 2007 as HB 176 is comprehensive. Failure to give the 7 day notice could, in conjunction with other factors, be viewed as fraudulent by a suspicious judge or jury. So it should be done.

The Land Trust as an Alternative to Unworkable Lease-Options

A well-drafted land trust provides an alternative to lease-option transactions, the traditional investor favorite, but which are now defined to be executory contracts under Sec. 5.062 *et seq*. of the Texas Property Code. What exactly is an executory contract? An executory contract includes any transaction that defers some action by either party that pertains to ownership or possession of real property into the future. The classic executory contract is the contract for deed. Section 2(a) 2 of the Code states:

> **An option to purchase real property that includes or is combined or executed concurrently with a residential lease agreement, together with the lease, is considered an executory contract for conveyance of real property.**

The effect is to place lease-options under the same burdens that apply to contracts for deed, which most investors consider unworkable. Although there is an exception for lease-options for six months or less, this is not usually a sufficient period of time to accomplish investor objectives; and tacking six-month lease-options together is not likely to fool a judge.

The net result of these statutory changes is that executory contracts (including traditional lease-options) are no longer advisable or even feasible in Texas unless the property is paid for or used exclusively for commercial purposes. In addition to stiff penalties, certain violations of the new statute are defined to be DTPA violations, which can result in treble damages plus attorney=s fees. So what alternative is available?

The land trust arguably falls outside the executory contract statute, so long as the trust is worded to provide for an option to purchase a beneficial interest in the trust (personal property), *not* an option to purchase the real property itself. Ideally, trusts also have the benefit of enabling

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the investor to easily get the property back in the event of default by terminating the trust, declaring the resident to be a tenant-at-sufferance, and giving 3 days notice to vacate before filing a forcible entry and detainer (eviction) action in justice court. Forcible detainers are effective in re-acquiring possession of the property in the overwhelming majority of cases. A minority, however, may require a statutory appeal to county civil court.

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