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UNDERSTANDING
VENDOR FINANCE & PROPERTY LAW

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UNDERSTANDING VENDOR FINANCE & PROPERTY LAW

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The Power of Vendor Finance

Found a property you want to buy but don't have enough money (or sufficient credit history) to finance it? There might be a way around it with the use of clever contract clauses.

With all the legal jargon and peppering of real estate contracts these days, real estate agents and investors are becoming more hesitant about the use of special conditions in real estate contracts with relation to vendor finance arrangements.

Almost every business engagement in Australia involves a financial transaction facilitated by either a bank or a financial institution that provide consumer credit services. For instance, e-commerce businesses entirely base their transactions on e-payments that originate from banks. In spite of this, you can still complete certain transactions such as buying property without necessarily going through a financial institution. Lets have a look at vendor finance in real estate transactions in Australia.

Definition

According to the Consumer Action Law Centre, seller terms contract is a legal way of selling property without the involvement of a third-party financier. In this arrangement, the property seller funds the entire property transaction while the property buyer agrees to make regular payments to the seller over a given period. These instalments may or may not attract interest. In some cases, the buyer is required to make a small deposit to the seller although this is not mandatory and the entire transaction does not involve mortgage arrangements. Property ownership passes from the seller to the buyer once the buyer completes all payments. As such, no financial institution is directly
involved in these types of contracts, an aspect that has made such contracts increasingly common in the Australian real estate market.

In Nutshell - Understanding Vendor Finance

While property is traditionally purchased by taking out a mortgage with a bank, you can also use vendor finance to skip the bank application process and secure your next property.

Often referred to as "seller finance", vendor finance is an alternative way to achieve home ownership without having to take out a mortgage with a traditional lender. Vendor finance also refers to ways in which you can start owning and paying off your home even if you have poor credit or employment history or you're unable to qualify for a traditional home loan for any other reason.

Vendor Finance is finance offered by a seller (a Vendor) to finance the sale of goods, services or real estate to a buyer (a Purchaser).

Most commonly, sellers offer "terms" to Purchasers to pay "some now, some later". The "some now" is a deposit, the "some later" is an arrangement to pay the balance price of the price by

Legal Backing

The legal backing for these seller-backed contracts varies across Australia. For starters, the Sale of Land Act 1962 has legal provisions governing so-called seller terms contracts in Victoria. In fact, the Consumer Action Law Center says that Victoria's Sale of Land Act is the most comprehensive compared to similar legal frameworks enacted by authorities in other states and territories. For example, section 7(1) of this act expressly prohibits the mortgaging of land or property that is subject to a terms contract. This means anyone entering into a mortgage-based transaction tied to such a property would be committing a criminal offence. Other regulations governing these contracts in Victoria include the Fair Trading Act (1999) and the Duties Act (2000).

The Law of Property Act 2000 governs seller terms contracts in Australia's Northern Territory while the Sale of Land Act 1970 governs sale of land under similar contracts in Western Australia. In Queensland, these contracts are subject to the Property Law Act 1974. Some sections in this legal framework are subject to other legislative pieces such as the Land Title Act 1994 (Qld) and the Property Law Act. Seller terms contracts in New South Wales (NSW) are subject to the Land Sales Act 1964. Currently, there are legal frameworks governing similar contracts in Tasmania and ACT. This means you should hire a lawyer with in depth knowledge of these legal frameworks if you intend to seek legal redress to resolve a transactional issue.

The Benefits of Seller Terms Contracts

For starters, seller terms contracts are attractive to consumers who are unable to access property mortgages from traditional financial institutions. This includes consumers with poor credit history, those without steady jobs, those without enough money to make mortgage down payments, as well as those with unresolved credit report issues. Mainstream lenders generally classify such consumers as high-risk borrowers and therefore tend to exclude them from a wide range of financial services.

Secondly, term contracts are also beneficial to property investors because they allow investors to minimise their initial investments while maximising their real estate footprint. In fact, savvy investors can use this strategy to find great property deals in towns and neighborhoods that are shunned by traditional financiers. Due to their nature (mostly involve the property seller and buyer), these contracts are particularly suited for property buyers looking for highly flexible payments terms. In other words, a term contract grants a buyer an opportunity to negotiate a bespoke payment plan.

A term contract would also be useful if you are planning to carry out major renovations on the property you are buying. This is because the minimal or no initial deposit will allow you to use the available financial resources to hire contractors (building, electrical, plumbing) and purchase the relevant building materials. What's more, you may also have to acquire a renovation permit depending on the local building regulations. All these engagements require money that could run into thousands of dollars depending on the scale of the renovation project, building permit fees and the applicable contractor fees.

When buying or selling a commercial property, seller terms contracts may be a better financing option for several reasons. To start with, the Financial System Inquiry Final Report published in 2014 found that small businesses and startups generally face higher financing costs compared to large and well-established businesses.

In addition, a survey carried out by Deloitte Access Economics found that a staggering 200,000 or 10% of all Australian SMEs face significant difficulties in accessing funding from mainstream lenders. As such, some SMEs are unable to expand or have no option but to forego potentially lucrative business opportunities. This state of affairs forces financially disadvantaged entrepreneurs to turn to funding solutions that are typically more expensive compared to those offered by mainstream financial institutions. Sadly, this can suck a business into an inescapable cycle of debt that could easily lead to insolvency. Luckily, SMEs can use terms contracts to acquire business assets such as warehouses and turnkey factories.

If you do not want to deal with the paperwork or the endless back-and-forth associated with the mortgage application process, consider entering into a terms contract with the seller. The

mortgage application process alone involves several steps including conditional approval, formal/full approval, property valuation, contract negotiation and preparation, perusal of mortgage documents, contract signing, and loan settlement. All these steps could take anywhere from four weeks to several months depending on the asking price and the availability of down payment funds. In comparison, seller terms contracts are not mortgage-based, meaning that you can close a property buying deal much faster. This transactional flexibility makes it easy for property investors to invest and divest at the right time.

Drawbacks

In spite of their benefits, certain aspects of seller terms contracts can be disadvantageous to real estate buyers.

Firstly, buyers/sellers in territories and states where the existing legal framework is not as comprehensive as that in Victoria may face difficulties enforcing these contracts. For example, according to the Consumer Action Law Center, seller terms contracts in New South Wales only apply to property transactions that are within a subdivision of five or more lots. This means you may be unable to claim your property title from an unscrupulous seller who is intent on using legal loopholes to defraud unsuspecting consumers. To avoid such a scenario, it is advisable to hire a competent real estate lawyer and make sure that he/she evaluates all contract documents before appending your signature.

What's more, without a sound legal framework, you may not have any legal right to the property you are making monthly/periodical payments to purchase, which means you would be more of a tenant rather than a property owner. Unfortunately, an investigation by the CALC found that the legal protection available to buyers is lax because seller terms contracts are not subject to the Residential Tenancies Act 1997. This drawback has led to calls in some states and territories for the enactment of new regulations that specifically address ownership issues surrounding these types of contracts. Besides this, property buyers are normally responsible for regular maintenance costs including repairs and local land rates. Such costs can saddle you with an unexpected financial burden if you were unaware of these expenses at the time of signing the purchase contract. It is also worth noting that sellers who egg on potential buyers to commit themselves with promises of early refinancing may not be entirely truthful.

Research carried out by the Consumer Action Law Center found that median house prices in many Australian suburbs had surprisingly fallen or remained steady since the 1990s. As such, equity in a property purchased through this type of arrangement may be minimal or amount to nothing if you opt for refinancing several years down the line.
To avoid getting into an unfavorable deal, you should carry out thorough and comprehensive property research that covers all bases including historical prices and local zoning laws. It is important to note that a property may be subject to state, territory, or both state and territorial zoning laws. At the same time, the interpretation of zoning regulations generally varies from one territory to the next meaning aspiring real estate buyers require sound legal advice.

Misrepresentation in Terms

According to the Consumer Action Law Centre, terms contracts are prone to misrepresentations that usually emerge after buyers have already signed the purchase contracts. Most of these misrepresentations revolve around the condition of the property as well as contractual terms and conditions. Resolving such issues, even in court, is not always easy because the aggrieved party has the burden of proving that the misrepresentations were intentional, not accidental. Moreover, filing a case in court translates to additional expenses that the buyer has to shoulder. The CALC warns that property buyers without prior experience in "terms contracts" are especially vulnerable to these misrepresentations. The same is true for people facing financial difficulties because they are unlikely to seek legal redress due to lack of money.

Some sellers charge interest rates that are higher than the rates charged by mainstream lenders. This is largely because they know that most of the buyers who opt for these types of contracts have no other viable way of acquiring property. For instance, when advertising their properties, some sellers use vague terms such as "buyer to pay interest at a rate that is two percentage points higher than the annual rate paid by the seller." Since this description does not even indicate the seller's annual percentage rate, potential buyers are unable to determine how much they can expect to pay per month accurately. Another risk related to this type of transaction is the risk of property repossession by the underlying mortgage lender. Remember some sellers are likely to be paying off mortgages meaning lenders could repossess their properties if they default on mortgage repayments.

Background Research

Extracting yourself from this legal mess could take years and drain your financial resources because banks have the financial muscle to pursue legal action for years. To avoid these inconveniences, carry out background research on prospective sellers to ensure you are not entering into a fraudulent transaction. Better yet, hire an investigator, preferably one with a background in law enforcement, to perform this task on your behalf. Although hiring such an expert may seem expensive, you will be able to avoid sellers who could plunge you into costly and disastrous legal problems in the future.

Overvaluation is another common problem faced by buyers of property under seller terms contract. In some cases, the overvaluation can be as high as 25 to 50% of the average price of similar properties in the same neighborhood, the CALC reports. This practice is especially common in neighborhoods where property values are low. More worryingly, the CALC says overvalued properties in low-income suburbs tend to be poorly maintained. This is in addition to having minimal visual appeal. Nevertheless, sellers inflate the asking price partly due to the demand fuelled by consumers who cannot purchase property through traditional lenders. Purchasing a property that fits this description is not financially wise because you are likely to end up spending more money on extensive renovations. You could also be ordered by the local authorities to tear down your newly acquired home and rebuild it from the ground up (if it is declared unsafe for human habitation by building inspectors). If you cannot afford a house in a better condition, look elsewhere or save money with the aim of buying a house the near future.

Aspiring first-time property buyers are often prone to over-committing themselves to payment plans and financial agreements that they cannot honor. This is due to several reasons. For starters, some consumers wrongly assume that institutions such as banks are purely evil or uncaring when they refuse to lend them money. However, they fail to recognise that banks hire extremely smart people who are well versed in money management and risk factors associated with financial delinquency. Moreover, the ANZ Survey of Adult Financial Literacy in Australia published in May 2015 found that more than 55% of respondents did not regularly use sources such as newspapers, radio, government publications, magazines TV, and the Internet to educate themselves about financial issues. What's more, only 48% of adults surveyed would trust financial experts and follow their recommendations. Surprisingly, women scored worse than men in terms of financial knowledge and access to financial education/information. This is worrying because uninformed consumers are likely to overestimate their financial literacy and plunge themselves into financial difficulties later. In general, you should trim down non-essential purchases and avoid additional debt if your financial situation is shaky. At the same time, strive to improve your financial literacy and keep abreast of developments in the financial sector.

Seller Terms Contract Features

Even if you have retained a lawyer, it is wise to scrutinise the purchase contract carefully. While doing this, pay special attention to the fine print because unscrupulous sellers usually hide unfavorable terms/conditions and legalese in this section. Make sure that legal terms denoting each party in the transaction such as "buyer", "purchaser", "seller", and "property owner" are clearly defined and legally correct. This is important because such terms are usually substituted for the names of the buyer and seller using wordings such as "the seller hereby known as" meaning any legal ambiguities could lead to ownership issues later. The sale contract should also state clearly the purchase price and provide details on the payment plan agreed by both parties. This includes interest terms, repayment period, number of installments, legal fees (if applicable), intervals between payments, deposit/down payment (if any), and penalties for late payments. Agree on a system/formula for confirming payments to avoid accusations of defaulting when you have faithfully upheld your part of the bargain. Make sure this agreement is included in the purchase contract.

Clarify each tiny detail including the nature of payments (cash, bank deposit) to avoid misunderstandings. Some experienced buyers even manage to negotiate for a percentage of the purchase price to be refunded in the event they default on payments. Another key financial issue is the party responsible for taxes or land rates. A good example is stamp duty, which varies depending on territory and property value. Luckily, all Australian states offer some form of stamp duty concession to first-time property buyers provided they satisfy the eligibility criteria. Regulatory authorities in some states are campaigning for abolishment of property duties because they constitute an additional financial burden that first-time homebuyers must bear. If you have doubts about tax-related issues, consult a financial and tax planning expert. This notwithstanding, stamp duty is payable on the full purchase price only after completion of all outstanding payments. On top of this, the sale document must address when, where, and how property ownership will pass from the seller to the buyer. Insist on the addition of a clause defining the order of events in the case of an unforeseen contractual issue such as defaulting on payments due to ill health or salary delays by your employer. Doing so takes care of potential succession/inheritance issues that could arise in the event a seller or buyer dies before the stipulated contract period elapses. While these issues may seem trivial, they can save you a lot of headache and thousands of dollars. The only downside to taking these precautions is you may have to hire a number of experts including financial, tax and estate planning experts.

In recent years, a new feature called "Mortgage Backed Finance" has become increasingly popular. As such, you should consider making it part of the purchase agreement. Mortgage Backed Finance refers to financing whereby the vendor/seller agrees to lend back to the seller part of the purchase price by transferring the property to the buyer in return for a payout style financial arrangement.

However, proceed carefully before agreeing to such an arrangement because the mortgage documents will have to include a Credit Code Disclosure Statement and comply with the National Credit Code*(need help). In this case, the buyer would be required to meet the eligibility criteria applicable to all mortgage applicants. As such, always seek expert advice and avoid making on-the-spur-of-the-moment decisions when property sellers dangle attractive financial propositions in your face.

Finally, make sure the sale document includes details on all the household furniture and appliances that are part of the deal. Do not assume that you will get any of these items automatically because the seller may have arranged to sell them independently. If they are part of the sale agreement, find out the modalities used to value them or else you will end up with expensive junk.

Conclusion

Consumers in Australia who are unable to purchase property with funding from banks should consider doing so via seller terms contract. This type of arrangement offers a lot of flexibility to buyers because they can negotiate repayment plans that suit their financial health. It is also gives property investors a lot of financial and operational freedom. Of course, you should consult a legal expert before getting into such a contract.

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