Subject To System
Preview Of What You Will Learn

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You Will Be Able To:

- Understand what the “subject to” financing option can do for you as an investor, as well as the risks that come along with it.
Acquiring real estate can be handled with many different approaches. Traditionally, you finance deals through banks, credit unions, and other home mortgage companies. However, sometimes dealing with banks can be challenging. If you don’t have a substantial amount of available cash or a great credit rating as a safety net, buying real estate can be downright difficult. As a real estate investor, no matter what your situation is, you will need to get creative with your financing. A great financing strategy to add to your belt is called “subject to” investing. This is a creative method of acquiring real estate; however, it must be done responsibly and with the proper knowledge and education. When you purchase a property subject to, you are essentially buying subject to the existing mortgage that is already in place. The original terms of the mortgage are kept as is, including the name in which the loan was purchased. The only difference is you are simply making the mortgage payments on behalf of the original seller until you decide on your exit strategy.

It’s important to note that with a subject to, you are not “formally” assuming the loan. The terms you create with the seller are between the both of you as long as you precisely follow the stipulations set forth when the arrangements were made.

Subject to financing requires little to no money down and, when used properly, can provide a huge profit. But the key is to be able to pinpoint the best situations in which to use it.

Let’s go over a sample situation that would create an ideal environment for a subject to agreement.

- Homeowners John and Linda purchased their house five years ago for $200,000. The remaining balance of that loan is $195,000; it was appraised for $260,000. The two racked up some credit card debt and medical bills and had to buy a new car causing them to have to go delinquent on their next mortgage payment in a few weeks.
- John also got offered a job and the couple has to move out of state and sell their home. When they approach a real estate agent, they find out that average days on the market are 180 days in their area. John and Linda do not have the luxury of time because they have to move immediately and do want their loan to go delinquent.
Introduction

- In walks the investor, who then informs John that they are not willing to pay more than $220,000 for the house. Insulted by the offer, John doesn’t like the option of letting thousands of dollars slip through the cracks.
- After John finishes explaining his situation, the investor tells him that he thinks he can still offer closer to the original asking price of $260,000, but reminds them that he is going to need to make a profit.
- He tells the couple about a “subject to” offer and explains that it’s an option that utilizes the existing mortgage, while he as the investor takes over the payments. He also goes over the following:
  - This agreement will keep the current mortgage in place for an estimated but not guaranteed six months, at which time the house will be sold, and John’s original asking price will be met
  - A payment account will be set up managed by an attorney or third party custodian and paid by the investor to ensure full integrity of the contractual agreement
  - Property is deeded to the investor, which obligates him to continue making the existing payments on the mortgage.
  - This agreement relieves John and Linda of the monthly debt for the mortgage payment, so they can move on with their life.
- The investor offers to pay closing cost and two months of mortgage payments upfront to the escrow account to solidify his offer and his intentions to make good on the contract. After discussing the deal with each other and realizing that their options and time are running low, both John and Linda agree to sell subject to at 235,000. Six months later, the investor has put $20,000 in improvements into the house increasing the value significantly. The investor lists with a realtor and re-sells it for $310,000 and pays off John and Linda’s mortgage company, and everybody wins!

You can see how subject to investing is one of the most powerful ways to buy properties from homeowners. Yes, the scenario outlined above was an ideal situation, but it could certainly happen to you if you have the wherewithal to recognize it.

Of course, you should keep in mind that buying properties subject to may not be the best solution for all scenarios. However, knowing how to utilize this strategy is a great tool to have in your arsenal for when the right opportunity presents itself. In this guide, we will dig a bit deeper into what this creative financing option can do for you as an investor, and how to minimize the risks that will inevitably come with it. Remember, the more creative techniques you have to purchase property or to structure a deal, the more likely you will be able to work with a motivated seller to find a potential solution.
Buying Properties Subject To

What most people don’t realize is, when they purchase a home subject to, they are in control. As an investor, you are the one who owns the home; the seller simply owns the loan. You will have the deed to that property. But before you get too excited, remember that with great opportunity comes potential risk.

Let’s review the pros and cons of using this creative finance option.

<table>
<thead>
<tr>
<th>SUBJECT TO PROS:</th>
<th>SUBJECT TO CONS:</th>
</tr>
</thead>
<tbody>
<tr>
<td>If done correctly, this strategy will provide monthly cash flow and equity.</td>
<td>You own the home and can’t change your mind, even if the market changes or you can’t sell; because you now have an ethical responsibility to the original seller.</td>
</tr>
<tr>
<td>You’re able to acquire properties without coming out-of-pocket with typical down payment amounts.</td>
<td>If you don’t make payments on time, you can hurt the seller’s credit.</td>
</tr>
<tr>
<td>Since your credit is not being used, you can purchase multiple homes with this strategy. This allows you to leverage your credit and purchase other homes through traditional means, if you desire.</td>
<td>There is a possibility that the lender could call the loan due.</td>
</tr>
<tr>
<td>The homeowner benefits because they can sell their property without many of the fees inherent to the traditional sales transaction, such as Realtor fees and other closing costs.</td>
<td>You will need to obtain a new insurance policy naming you or your company as the insured on the policy.</td>
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**Helpful Tip**

In some states, Realtors could be fined or lose their license because it can be considered against their code of ethics to assist a person in violating a clause in the real estate contract (more about the due on sale clause below).
Possible Risks to You and the Seller

As investors, we do our best to minimize the risk involved with any transaction. Building strong relationships and writing solid contracts are especially important with a subject to deal to ensure the seller follows through and pays the mortgage with the funds you’re paying them. Buying subject to carries risks for homebuyers and may expose sellers to liability. Because of these potential risks, it is strongly recommended that you seek legal guidance on the required paperwork and risk adherence. Below are the three main risks to be aware of.

1. Due-on-Sale Clause: The “due-on-sale” clause is probably the most talked about, feared, and misunderstood topic. Almost all mortgages have a “due-on-sale” clause that allows the lender to accelerate the loan, calling for immediate pay-off if they discover that the seller has passed ownership of the property to someone else. If the lender discovers the transfer, they may call the loan due, requiring the loan to be paid in full in 30 days. A possible situation may occur where you are right in the middle of your rehab when you receive that notice. If it cannot be paid, the lender has the option of beginning foreclosure proceedings. In most cases, it’s unlikely that it will occur, but it can happen. It’s been our experience that lenders aren’t very concerned about where the payment is coming from, so long as they receive payment, but it’s important to know that is not always the case.

2. Lien Obligations: Remember, you will have the obligations to satisfy all liens and encumbrances before you can sell the property; so make sure to do a title search. You may be told that there is only a first mortgage; but once you dig in, you could find much more. When your obligation to pay is greater than the profit you will make on the deal, it just won’t be worth your time.

3. Late Payments: Entering into a subject to real estate contract requires a high level of trust. If an investor starts making mortgage payments late, or doesn’t payment at all, the seller can default on the loan and possibly cause a foreclosure. The integrity that the homeowner counted on for making payments is then lost.

In order to overcome the potential risks, it is imperative to disclose in writing any or all of the above “problems” mentioned above could happen. It is honorable business practice for a seller to disclose the extent of liability he or she may have. Of course, this disclosure will also benefit the investor by means of helping to forgo a lawsuit if something goes wrong down the road.

Helpful Tip

If the sellers are going to file bankruptcy – do NOT go through with the deal! If you do, the bankruptcy court can come back and make you a creditor. They can make you pay the equity! You do not want to get caught up dealing with the seller’s issues in Federal bankruptcy court. We also recommend filling out subject to contracts in the presence of an attorney with a live notary available to authenticate the documents.
As mentioned earlier, not every deal you come across will be an opportunity to introduce a subject to finance option. However, you should be able to recognize these opportunities when you see them. For instance, if you find homeowners that are behind on their mortgage, you can offer subject to financing as a way out. After all, any successful real estate transaction will cater to the seller’s needs and this situation is no different. There will be some cases where you will realize that a subject to agreement is what would work best for your sellers.

### Types of Deals That Fit Subject To Financing

- Properties with existing equity
- Properties with minimal equity
- Multi-family homes with cash flow
- Rehab properties
- Any properties where the numbers make sense for both parties

### Why Do Sellers Consider Subject To?

Usually, but not always, most homeowners who entertain the idea of a subject-to deal do so because they are behind on payments and cannot catch up. Others may need to move quickly because of personal life circumstances. What you will typically find is that sellers are willing to trade equity for piece of mind. Remember, real estate business is often a problem solving business; so you should always be prepared with a solution for every problem you may come across. Here are some key things to listen for that will give you a signal to consider offering subject to agreements:

- Foreclosure
- Sickness
- Death
- Divorce
- Job change
- Behind on payments
- Old age
- Urgent need for cash
- Inheritance
- Sudden need to move
- Owners don’t want hassle
- Live in another part of the country
- Tired of dealing with renters
Determining The Seller’s Motivation

Just as each property is different, each homeowner’s motivation for selling their property is unique as well, and so will be your choice of financing. Once you have a complete grasp of the different motivations sellers may have and the different funding options available to you, you can figure out how to best structure your deal. When you are approaching an opportunity to make a deal with a seller, it is in your best interest to understand their needs so that you can address them. As in any deal, the better you can understand motivations for selling, the better you will be able to meet their needs and the more likely the possibility that you will land the deal. Because a subject to contract may be a bit scary for the seller, you’ll need to uncover what is so important to this person to make this deal have to happen. In order to discover what that is, you have to be an active listener and try to understand more than just the surface-level motivations. For instance, if there is a divorce causing the need to sell the house, try to get your seller to open up about how this move can serve as closure for them, as one last thing to worry about. By getting the seller to open up about what is really going on, you’ll not only be gathering useful information to understand your seller, but you will also be building rapport and gaining trust from them as well.

Gathering Necessary Information

There are a few key details you will need to be able to make an informed decision as to whether or not you should offer a subject to financing agreement with a seller.

Here are a few questions you want to ask in order to gather necessary clues:

WHAT DOES THE SELLER NEED IN ORDER TO MOVE ON?

- Why do you want or need to sell this home?
- How much money do you need to complete your move?
- Do you need to take out another mortgage within six months?

Helpful Tip

A mortgage is debt on the seller’s credit history. They may or may not qualify for a mortgage based on their debt-to-income ratio. Therefore, if the seller needs to move and obtain another loan, a subject to deal may not be ideal.
WHAT IS OWED ON THE PROPERTY?
- Do you have a second mortgage?
- Do you have a home equity line?
- Have you done any repairs, such as heating and cooling, or any large project where you had a home repair merchant come out that may have added as a credit of the last 3-5 years?
- Do you happen to know what the balance is on that mortgage?

Helpful Tip
Be wary of Adjustable Rate Mortgages (ARM). ARM’s can increase quickly and you don’t want to find yourself with sky-high payments and a negative cash flow property. Low fixed rate loans are optimal when doing a subject to deal.

WHAT IS THE MONTHLY PAYMENT LIKE?
- Tell me about your current mortgage; what is your monthly payment?
- Do you know if that mortgage includes escrow?
- Are you current with your mortgage or have you ever missed a payment?

Due Diligence Checklist:

Research State Laws
- Every state varies with how they deal with this transaction and some are stricter than others, don’t wait until it’s too late to find out where you stand

Research the Terms of the Loan
- Prepaid penalties?
- Adjustable or fixed rate?
- Has the loan been modified or altered?
- Are the taxes and insurance paid or included in the monthly payment?

Check Utilities
- Is there a past balance that you have to pay?

Once you feel confident that this deal is a good for subject to financing, you can begin to offer it as an option to your seller.
Many sellers will have never heard of a subject to deal. So when you introduce this idea to them, it is important that you play the part of a consultant and a trustworthy friend. You’ll need to educate them on this strategy as well as constantly show them how beneficial it can be for them to agree to this. Although it may seem like a complicated subject at first, once you break down the details, it really is quite simple.

Creating the Perfect Pitch

Homeowners are understandably nervous when you introduce the idea of a subject to deal. After all, their name is on the note and their credit is on the line. You need to prove to them that you are trustworthy and that you will make the payments on time.

The perfect pitch is geared around your seller’s motivation. You need to outline just how you will be working towards a win-win situation. For example, you will be working on renovating and selling the home at a higher price, while they will have the freedom to move forward knowing that things are well taken care of.

Compare this option to the alternative. Yes, the seller would benefit from a typical cash transaction, but it would be at a lower price. Also, if you are dealing with a seller with poor credit, remind them of the benefits of improving credit with consistent payments.

You want to always complete these transactions with the utmost integrity. Remember, the seller trusts you to make payments on their behalf. Your word is the most important thing that you have, so make sure to keep it. When you are explaining the details of the transaction, you need to make it crystal clear to the seller that the loan will stay in their name until it is paid off, and that it will continue to show on their credit report. If at any time you notice that this will be problem for them, you should not go through with the deal.

Helpful Tip

You must have a good relationship with a real estate attorney who specializes not only in closings, but also in other real estate matters including creative financing. This way, he or she can guide you through the process and protect EVERYONE’s interests.
Overcoming Common Objections

Being that subject to financing is a new and foreign concept to most sellers out there, you are inevitably going to hear objections. You have to be able to understand the difference between a real objection, and an objection derived from fear. A fear objection is usually based on misunderstanding or lack of communication. This you can fix. A real objection is much deeper than that. For instance, if you've fully explained to the seller that the loan will stay in their name, yet this is an automatic problem for them - then do not buy the property. It will become a huge headache down the road if you are not on the same page from the beginning. You should never feel as if you have to “convince” a seller to sell to you this way. After you've explained all the details and demonstrated that you are a credible and trustworthy investor, they should be thrilled that you have a way to solve their problem and be willing to do whatever it takes to make the transaction work. Before you reach that level of excitement and understanding, you are going to get a few fear objections. Here are four common ones that you can overcome along the way:

**Fear of the Due-on-Sale Clause:** This clause is going to rear its ugly head more than once throughout your transaction. You are aiming to be as open and honest as possible with your seller, so you will have to explain this clause to them right away and inform them of all risks. The due-on-sale clause states that if the owner of a property transfers, the lender CAN call the loan paid due in full. The due-on-sale clause gives the lender the right to demand payment of the remaining balance of the loan when the property is sold. This is a contractual right.

**Fear of the Investor:** Most often, investors don’t always have the best reputation in the real estate industry. The bottom line is that most people just don’t understand what we as investors do. This is why building rapport is the single most important factor leading to a mutually satisfying outcome for you and the seller. Rapport occurs when you and your counterpart attain trust and a positive relationship. Building credibility goes right alongside with rapport. People are going to usually be skeptical at first – so when you first walk into a seller meeting, it’s vital that you remain confident in your business and your presentation. The key is to take control of the meeting right from the start and really set the tone. Start by being truthful in all aspects of the relationship. Fully disclose everything that you plan to do and be transparent. We have found that honesty and full disclosure really helps people to feel at ease. A comfortable seller is a happy seller.

**Helpful Tip**

When dealing with subject to financing, an important part of your credibility is your credit history. It may be a good idea to insert your or your business’ most recent credit report into your credibility packet just to prove that you aren’t all talk.
Fear of Time: The question of “How long will it take?” will usually come up during the process. The seller will want to know how long they will have to stick their neck out on this deal, and when exactly they can breathe easy with a mortgage paid in full. Your response should be something similar to this:

“I will be anxiously making the repairs once we close; my anticipation is in 4-6 months, we will have that mortgage paid off and you will receive a note that says ‘paid in full’ from the mortgage company. I can’t guarantee those time parameters, but it’s our goal.”

By adding in that detail of the note from the mortgage company, you are helping to paint the picture and reinforce that we are all shooting for a win-win situation.

Fear of Consequence: When the seller places their existing mortgage in your hands, of course there is going to be concern. What happens if payments aren’t made? We’ve found it best to try and preempt this common objective by explaining early on that you will be using a loan servicing company or attorney to make the payments. Another idea is to open a savings account - in this case, you would make the payment into that account and make arrangements for the amount to be automatically deducted every month. You can set the seller up with online access to view the account and see that the payment was made.

Helpful Tip

Give the seller an opportunity to consult with legal counsel. Often, investors act in haste to secure their signature on the purchase contract in order to “beat out the competition.” The danger in this approach is that the seller may later claim he/she was misled and/or misunderstood the details of the transaction. A court could very possibly defer to the inexperienced seller, as opposed to a seasoned investor.

Completing a Subject To Contract

Overall, the paperwork involved in this financing strategy is the same paperwork involved in any other transaction. Subject to real estate contracts are legally binding and enforceable in a court of law. Contracts must be recorded through district courts where the property for sale is located. Ownership rights are “subject to” fulfillment of contract obligations. In some states, if buyers default on subject to contracts, ownership rights typically revert back to the property owner. If this occurs, buyers forfeit all invested funds. However, it’s important to make sure you always seek competent legal advice from a lawyer when you are putting together a subject to contract because rules and laws are different in each area.

When the time comes to fill out the paperwork, your real estate attorney will add to the “special provisions” section of the sales contract: “This transaction subject to the existing mortgage with…” Then, you will include all the information about the loan, such as: the name of the lender, the loan number, the original amount, the monthly payments, all names on the note and any other relevant information.
Communicating with Sellers

This can also be referenced on the HUD-1 settlement statement on line 203 (Under Summary of Borrower’s Transaction) and line 503 (Under Summary of Seller’s Transaction). It says: “existing loans taken subject to."

<table>
<thead>
<tr>
<th>120. Gross Amount Due from Borrower</th>
<th>420. Gross Amount Due to Seller</th>
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<tbody>
<tr>
<td>200. Amount Paid by or in Behalf of Borrower</td>
<td>500. Reductions In Amount Due to seller</td>
</tr>
<tr>
<td>201. Deposit or earnest money</td>
<td>501. Excess deposit (see instructions)</td>
</tr>
<tr>
<td>202. Principal amount of new loan(s)</td>
<td>502. Settlement changes to seller (line 1400)</td>
</tr>
<tr>
<td>203. Existing loan(s) taken subject to</td>
<td>503. Existing loan(s) taken subject to</td>
</tr>
<tr>
<td>204.</td>
<td>504. Payoff of first mortgage loan</td>
</tr>
<tr>
<td>205.</td>
<td>505. Payoff of second mortgage loan</td>
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</table>

**Helpful Tip**

Because you don’t have a payoff from the bank, you won’t know the exact amount left on the mortgage yet. You will need an Authorization to Release Information Form from the seller. This form will be vital because once you send this into the bank, this will allow you to call and inquire about the loan currently in place.
When dealing with any creative financing method, you should always be careful of making the common mistakes. It may be easy to become caught up in the process and forget about the simple details that make all the difference. Here is a list of common mistakes we’ve encountered:

**Forgetting About Insurance** - As soon as you purchase the home, you must buy new hazard and title insurance:

*Hazard insurance policy:* As soon as the deed exchanges hands, the old policy disappears. NEVER take deeded, legal ownership of a house without obtaining hazard insurance that goes along with it. You can be exposed to a world of hurt you aren’t ready to defend.

*Title insurance policy:* You will take ownership of the property, so the insurance policy on the property needs to be changed to reflect you as the new owner. Amending the current policy or obtaining a new one can accomplish this. Discuss your plans with an attorney to make sure that they will be able to write title insurance for you. If a particular title company states that they cannot write title insurance for subject to transactions, try another title company. Having title insurance is important for when you go to resell the property. Similar to car insurance policies, if you leave something uninsured for a period of time, the insurance companies are less likely to reinsure.

**Agreeing to Pay Too Much For a Property** - You never want to overpromise in real estate; especially when your seller is putting so much faith and trust in you as they are with a subject to financing agreement. Sit down and crunch the numbers before you make an offer, and then make sure your seller understands where that offer came from and how you’re going to deliver.

**Failing to Vacate Homeowners** - The day you close and become the owner, the homeowners should be gone. If they need an extra week before they move, then wait an extra week to close. Right before you close, you should be walking through a vacant house, just as with any other normal transaction.

**Misleading the Lender** - Be very careful not to mislead the lender with respect to the due-on-sale clause, especially if the lender inquires about the transfer. This is particularly important when dealing with a federally insured loan, because of the laws concerning “concealment” with respect to government agencies.
Avoiding Taxes - Some states may require transfer taxes. Never try to conceal the transfer to avoid paying these taxes.

Not Having An Exit Strategy - Before you jump into this kind of investment, you need to not only know your numbers, but understand your exit strategy as well. There are many possible exit strategies; however, the key principle to remember that your strategy needs to be short term. The ideal exit strategy should be completed within a maximum of 6 months.

Helpful Tip

Remember, you will have to sell this house quickly to appease yourself and the seller. Make sure you have already developed a stocked buyers list so that you have plenty of options when it comes time to turn around and sell this property.
Wrap Up

We remain very conservative and cautious when buying this way. But, when done right, subject to purchases are a legitimate way to buy properties and work well for both the buyer and the seller. Here is a wrap up of what we've learned:

**#1**
**LOCATE DEALS THAT FIT**
Only go into a deal with a seller if you feel they are a good fit, and the seller is 100% on board.

**#2**
**REACH AN AGREEMENT**
The seller will leave their mortgage in place, while the buyer agrees to take over their payments. Make sure everyone is on the same page and every detail has been covered.

**#3**
**CLOSE USING SUBJECT TO**
Close with an attorney. The attorney will do the title work, and make sure everything is above board from a legal perspective.

**#4**
**INSURE THE PROPERTY**
Obtain hazard insurance naming you as the owner/insured. Speak with a title company to obtain title insurance. If vacant and under significant rehab, a builder's risk policy should be used instead.

**#5**
**REHAB THE PROPERTY**
While making payments on the original mortgage, continue with the rehabbing process & prepare to sell the home.

**#6**
**LIST AND SELL**
Once property is sold, pay off the remaining mortgage on behalf of seller, and provide them with closing bonus, if agreed upon.

**STEPS TO A SUBJECT TO DEAL**
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