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SELLER'S LIABILITY AFTER AN ASSUMPTION

Many sellers are under the misconception that a seller is automatically released from personal liability when a buyer assumes an underlying loan. To the contrary, the general rule is that the original borrower remains personally liable on the assumed loan. As a practical matter, though, the seller's on-going liability usually is more theoretical than real. This is true because lenders nearly always elect to foreclose their deed of trust nonjudicially rather than to sue on the note. If the deed of trust is foreclosed nonjudicially, then the underlying obligation is canceled and the lender has no further recourse. Of course, the best protection for the seller is to require a substantial down payment (i.e. 20% or more of the sale price), to minimize the risks that the buyer will default in the first place or that the lender will sue on the note if the buyer does default.

There is an exception to the general rule with respect to a loan containing a due-on-sale clause. Under a federal regulation applicable to all lenders, the lender *must* release the original borrower from personal liability if (1) the loan is secured by the seller's principal residence, (2) the buyer becomes personally obligated to the lender, and (3) the lender consents to the assumption, and thereby waives its right to call the loan due. Since most institutional loans contain due-on-sale clauses and all due-on-sale clauses are now fully enforceable, this regulation frequently applies in instances where the lender will permit an assumption.

In some cases, the lender will permit a novation (substitution of liability) in favor of a qualified buyer even where the federal regulation does not apply. Of course, if a novation is requested, then the buyer must meet the lender's qualifying criteria, regardless of whether the loan documents contain a due-on-sale clause.

If the existing loan is a VA loan, then a novation alone does not relieve the seller from the indemnity obligation in favor of the government; the seller continues to be liable to the government if the lender makes a claim on the VA guarantee. In order for the seller to be released from both the existing loan documents and the indemnity obligation, the buyer must be an acceptable credit risk to the VA and must expressly assume the indemnity obligation. In addition, the seller’s VA entitlement may be restored if the buyer is also a veteran with sufficient unused entitlement to substitute the buyer's own entitlement for that of the seller.

An assumption may still be attractive even though the lender may charge an assumption fee and increase the interest rate, because (1) the assumption fee typically is lower than an origination fee for a new loan (1% compared to 2-2½%, on the average), (2) the interest rate may be slightly below the current market rate (usually ¼%), and (3) certain closing costs can be avoided (i.e., the appraisal fee and lender's title insurance premium).