A Reprint from *Tierra Grande*

flipping

By Judon Fambrough

The recent surge in property values has rekindled rapid exchange of property, better known as "flipping." In some cases, eager buyers purchase the land sales contract from another buyer whose sale has not yet closed. While the practice pushes land values up, real estate practitioners should be aware of legal complications inherent to such transactions.

Restraints on Resale of Property

Texas law supports the public policy preventing unreasonable restraints on resale of property. Property is freely transferable at any time. Land ownership includes the right to sell, mortgage or otherwise transfer the property. Unreasonable restraints are void and unenforceable.

Unlawful restraints occur most often in wills. Say, for example, the deceased leaves property to family members and forbids its sale to certain individuals or for a certain period. Texas courts generally disregard this imposition and rule that heirs may freely transfer the property to anyone at any time.

Some question whether a right of first refusal (sometimes referred to as a preferential right to purchase) places an unreasonable restraint on transfers and thus is void and unenforceable. Two appellate cases ruled the right does violate the restraint on transfer. One case was

decided in 1960 and the other in 1981; both involved oil and gas leases.

While Texas case law does not favor restraints on transfers, federal law indirectly imposes restraints. The Department of Housing and Urban Development (HUD) issued a ruling limiting, to some degree, the financing of flipped property.

Basically, if the seller of a single-family residence purchased the house within the past 90 days, the buyer is ineligible for Federal Housing Administration (FHA) financing. This also is the case if the buyer acquired the property under an assignment of a purchase contract (24 CPR, Section 203.37a). The complete ruling can be read at mbaa.org/resident/.

Exceptions do exist. For example, HUD's resale of single-family residences classified as real-estate owned properties in revitalized areas is exempt.

Limitations on Assignment of Contracts

As a general rule, Texas views all contracts as assignable, just as all property is transferable. In fact, the definition of an assignment parallels the definition of a sale. An *assignment* is a transfer or grant of all the seller's rights, title and interest in property or in a contract.

Texas law places some limitations on the assignment of sales contracts. For example, contracts providing extension of credit, such as owner-financed transactions, cannot be assigned. The seller's dependency on the creditworthiness of a particular buyer negates an assignment. Contracts involving character, skill and confidence cannot be assigned.

And, this exception has an exception. Any contract may be made assignable by its terms. That is, an otherwise nonassignable owner-financed sales contract becomes assignable if the language in the agreement specifies so. This may lead to some unintended consequences.

A 1953 Texas appellate decision involved an owner-financed land sales contract. The seller presumed it was not assignable. However, standardized legal language stated the contract "shall be binding upon the parties hereto, their heirs and *assigns* and legal representatives." The court ruled that the use of the word "assigns" indicated an intent to make it assignable.

Language Prohibiting Assignment

This raises an interesting question. If a contract can be made assignable through its terms, can it likewise be made nonassignable?

Provisions prohibiting assignment frequently appear in oil and gas leases. Mineral owners forbid the lease from being assigned altogether or to a specific oil company. Language prohibiting assignments falls into two categories. It may prohibit all assignments or permit them with the seller's prior consent.

Language forbidding all assignments is strictly enforced. Any attempt to assign the contract renders the assignment void, and the underlying contract terminates. The person attempting the assignment forfeits all rights in the contract.

Again, Texas recognizes a narrow exception that is important to real estate practitioners. In *Reuben Donnelly Corp. v. McKinnon,* the court held that language forbidding an assignment was not, in itself, sufficient to prevent an assignment. Because the contract did not specify the consequences for breach, the violation clouded title to the land but did not render the assignment unenforceable. To avoid this, real estate practitioners may recommend that any contractual language denying assignments be followed with "any attempts to assign this contract shall be null and void and the contract shall terminate."

At times, stating the consequences for a breach raises another problem *(Trafalgar House Oil and Gas, Inc. v. De Hinijosa)* that practitioners should avoid. In this case, the mineral owner inserted a provision in the oil and gas lease stating the lease could be assigned but only with the mineral owner's prior consent. Any violation called for liquidated damages (damages agreed to in advance as just compensation for a breach) in the amount of $1,000. As long as such damages are reasonable, the agreement is enforceable. Otherwise the courts view them as an unenforceable penalty.

Trafalgar breached the no-assignment provision but refused to pay the liquidated damages, contending they were not reasonably related to the harm. The Texas appellate court found to the contrary, ruling that the expenses incurred by the mineral owner hiring an attorney and conducting a check of the deed records would more than exceed this amount.

Texas statutes likewise contain a narrow exception to the no-assignment provisions. In *McAleer v. Eastman Kodak Co.*, Eastman took a contract from McLeer containing a no-assignment provision. Eastman later assigned the contract to one of its newly created companies wholly owned by Eastman. McLeer sued, contending the assignment was null and void, and the contract terminated by the breach.

The appellate court upheld the assignment based on the definition of "merger" in Texas Business Corporation Act, Section 5.06. The act stipulates that when a merger occurs, "all rights, title and interest to real estate and other property shall be allocated to and vested in the surviving or new corporations . . . without any transfer or *assignments* having occurred."

Thus, mergers between corporations do not violate any no-assignment provisions according to the Business and Corporation Act. This rule prevails even though the merged companies enter a formal assignment.

In Texas, generally speaking, all property is transferable and all contracts are assignable. But take note of these exceptions.

Assignment with Prior Consent

What if contract language permits assignments but only after the other party consents? Is this enforceable?

Apparently so, gauging from statutory language in Section 91.005 of the Texas

Property Code, which provides that, "During the term of a lease, the tenant may not rent the leasehold to any other person without the prior consent of the landlord."

Some tenants have argued that while the law prohibits subleasing, it does not prevent assignments. An assignment, they said, is a transfer of *all* one's interest in property or a contract, while subletting is a transfer of anything less.

However, Texas courts have ruled, without exception, that the statutory prohibition applies to assignments as well as subleases, and is by law a part of every lease. Landlords need not approve an assignment or sublease nor can they be held liable for unreasonably failing to do so.

While the statute prohibits assignments and subleases, it does not state the consequences for a breach. Older cases hold that a violation causes automatic forfeiture of the lease, allowing the landlord to recover possession of the premises as well as damages against the tenant. In these cases, the sublessee, after the prohibited assignment occurs, is a trespasser and has no right of possession.

More recent cases, though, maintain that the contract is rendered voidable, not void. The landlord has the option of either recognizing the assignment as valid or declaring the contract void, regaining possession and suing the tenant for damages.

Defining 'Unreasonably'

Some contracts require prior consent but qualify it by stating "consent cannot be unreasonably withheld." Does this wording clarify or confuse the issue? According to the case of *Mitchell's Inc. v. Nelms*, the wording creates additional problems.

Mitchell refused to consent to an assignment. Nelms sued, alleging consent had been unreasonably withheld. After reviewing decisions from other states, the Texas court held that the language was enforceable. Mitchell could be sued for damages if consent had been unreasonably withheld. The court then attempted to define the term "unreasonable" based on Texas cases.

One court equated an unreasonable decision to an arbitrary one, or one made without fair, solid and substantial cause or reason. Another case held that a decision is unreasonable when it is made with no room for difference of opinion among reasonable minds. Other Texas courts held that the term conveys the same idea as irrational, foolish, unwise, absurd, silly, preposterous, senseless or stupid.

Real estate practitioners engaged in contracts with a "reasonable" standard may suggest inserting definitions or guidelines regarding what is "reasonable" to avoid litigation.

Fambrough (judon@recenter.tamu.edu) is a member of the State Bar of Texas and a lawyer with the Real Estate Center at Texas A&M University.

REAL ESTATE CENTER

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.