The Perils of the Contract for Deed

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1. Introduction

Anyone who practices in real estate or consumer law has likely come across a contract-for-deed transaction gone bad. These transactions go by many names, including "rent to own," "owner carry," and "lease option," but they all have the same basic structure: a buyer purchases property (typically a single-family house) over time, making payments toward the purchase price over a period of months or years, and receiving title to the property after making all required payments.

There are many sensible reasons why people would do these transactions, but they usually come down to the buyer not having any other financing options and the seller being willing to take a chance on the buyer.

Many times, these transactions go off without a hitch. Attorneys generally don't see these transactions because the parties typically draft the documents themselves, and when the deal goes right there's no reason to call a lawyer. But when these transactions go bad, they can go horribly bad. These situations can quickly raise a host of thorny legal issues – both for the buyer and the seller – that can make what everyone thought would be a simple deal become horribly complicated.

This article will attempt to address the issues that often arise when contracts-for-deed go bad and explain why, in most situations, they are not advisable. It will also address the strategic options of both sellers and buyers in litigation. Importantly, this article does not explore all the nuances of the law in this area, as such a discussion could fill volumes.

2. Discussion

a. Legal Title versus Equitable Interest

By its nature, a contract for deed is a different animal. In most real-estate transactions, the buyer pays the purchase price at closing and receives a deed to the property. If the buyer has used financing, her lender will record a mortgage with the Register of Deeds in the county where the property sits. In these situations, there is a clean break in ownership: once the seller signs the deed and it is recorded with the appropriate recording office, title transfers by operation of law. In addition, the parties' respective interests are all public record.

This is not the case with contracts for deed. In these situations, the buyer purchases the property in installments. Many times, the contract for deed goes hand-in-hand with a lease agreement, with the buyer making monthly rent payments and a portion of each rent payment going toward the purchase price. In these situations, there is not a clean hand-off of the property from seller to buyer, but an incremental transfer of ownership over years. As a result, the seller remains the owner of record, even if the buyer has paid off most of the purchase price.

But just because the seller remains the owner of record does not mean the buyer is getting nothing for her payments. As the buyer makes payments, she builds up an *equitable interest* in the property. On occasion, buyers will file an Affidavit of Equitable Interest with the Register of Deeds, which puts the public on notice of this interest.

If the buyer succeeds in making all required payments, the seller must deliver a deed to the property to the buyer, and that equitable interest becomes a legal interest. But if the buyer fails to make all payments, that equitable interest remains. This is where things can get complicated.

b. The Buyer's Equitable Interest after Default

In a traditional purchase with financing, if a buyer fails to make the required mortgage payments, the situation is simple: the lender files a lawsuit to foreclose the mortgage, obtains a judgment of foreclosure for the amount due, has the property sold at a sheriff's sale, and then uses the sale proceeds to satisfy the balance on the mortgage. If the property does not sell for enough to satisfy the mortgage balance, the bank may take a deficiency judgment against the buyer. If the property sells for more than the mortgage balance, the remainder is paid to the buyer. In any variation of these scenarios, the buyer remains the record owner of the property until a sheriff's deed is recorded in the name of the successful bidder at the sale.

If a buyer purchases property through a contract for deed and fails to make the required contract payments, the situation is not so simple. In these situations, the seller often claims the buyer has simply failed to make required lease payments, treats the amounts paid toward the purchase price as "liquidated damages," and attempts to evict the buyer as a mere tenant;[1] indeed, the idea of selling the same property over and over again can be attractive to unscrupulous real-estate investors. Many buyers in these situations do not realize they are more than mere tenants, so they end up being evicted and losing the benefit of the amounts they have paid toward the purchase price.

Regardless of what unscrupulous sellers may want to believe, those who purchase real estate through installments have an equitable interest that is just as valuable as any other interest in real estate.[2] If a buyer asserts an equitable interest in the property, that interest cannot be extinguished in a forcible detainer (eviction) action.[3]

But unlike a traditional purchase with financing, in which the buyer enjoys legal title to the property even if she owes more on the mortgage than the property is worth, a buyer in a contract for deed must meet minimum equity requirements for a court to recognize her as having an equitable interest. As early as 1940, the Kansas Supreme Court stated:

> If the down payment by the tenant-vendee has been negligible, and his monthly payments have been but few or have only been paid irregularly, to the manifest loss of the owner-vendor, the contract will ordinarily be enforced according to its terms.
>
> But if the monthly payments have been made with reasonable promptness and have been made for such a length of time that their aggregate amount constitutes the equivalent of a substantial payment on the purchase price, or where substantial improvements have been made by the tenant-vendee, then equity may not permit the interest of the tenant-vendee to be summarily extinguished in forcible detainer, but will deal with the situation according to equitable principles, and may require proceedings as in equitable foreclosure before the interest of the latter can be extinguished.[4]

How much does a buyer have to pay toward the purchase price before it is deemed "substantial?" There is no exact measure, but there are guideposts. For example, the Kansas Court of Appeals in one case held that a payment of eight percent was not enough,[5] but in a subsequent case it held that a payment of 8.73 percent was sufficient.[6] As a general rule of thumb, if a buyer has paid off at least eight percent of the purchase price, whether through cash or improvements, she likely has an equitable interest that cannot be disregarded in a forcible-detainer action.

c. Prosecuting and Defending These Claims

Inevitably, a seller dealing with a contract for deed buyer in default will attempt to evict the buyer as a tenant. When this happens, the buyer must bring a counterclaim to establish her equitable interest in the property and move the court for an order elevating the case to Chapter 60.[7] This effort can lead to preliminary litigation as to whether the tenant has an equitable interest in the property, and therefore whether the case must be elevated to Chapter 60.

If the court decides the buyer has not accumulated an equitable interest in the property, then the matter typically resolves as a forcible-detainer action. If the court decides the buyer has accumulated an equitable interest in the property, that interest must be resolved through an equitable foreclosure. The first complication of equitable foreclosures is there are no guiding statutes.[8] Although the Kansas Court of Appeals has noted

that "[i]f the purchaser defaults, the vendor may foreclose the contract under the foreclosure laws of the state," it has also noted that

> Depending upon the equities, there is a broad range of potential resolutions to the suit. The court may (i) strictly enforce the contract in accordance with its terms, upholding the forfeiture of the buyer's equity in the premises, (ii) find that a default has occurred, but give the buyer a deadline by which he can pay off the balance of the purchase price and succeed to fee title, (iii) find that the forfeiture is inequitable and compel the seller to return a portion or all of the purchase price previously paid, (iv) find that the contract is really a mortgage, and require the seller to institute foreclosure proceedings, or (v) deny the forfeiture and reinstate the contract.[9]

As a practical matter, this means courts have the power, sitting in equity, to "give whatever relief the facts warrant."[10] This can feel like cold comfort for seller and buyer alike, as neither will be able to accurately predict what resolution the court will craft. However, in one instance the Kansas Court of Appeals upheld damages being "the difference between the fair market value of the land at the date of cancellation of the contract and the principal balance outstanding on the contract".[11]

For sellers who are savvy in the world of contracts for deed, attempting to ignore a buyer's equitable interest in the property and quickly evict a buyer can result in additional liability under the Kansas Consumer Protection Act (KCPA) for a host of deceptive or unconscionable acts or practices.[12] This exposure can be aggravated when dealing with buyers who do not speak English[13] or those who enjoy enhanced protection under the KCPA.[14] When representing buyers in these situations, the prospect of liability under the KCPA can serve as meaningful leverage in obtaining an agreed, equitable resolution.

d. Avoiding these Problems

When representing buyers or sellers in the negotiation of contracts for deed, the best way of avoiding the uncertainty of ensuing litigation is not to structure the transaction as a contract for deed in the first place. The possible structure of these transactions is limited mostly by the creativity of the parties, but the key restriction is that rent or lease payments do not have the effect of reducing the purchase price. The parties can agree to a specified option price, or to have increments by which the buyer has different options for different prices. But the litigation problems that come with contracts for deed likely will never overcome its potential benefits.

Conclusion

Contracts for deed involve an interesting interplay of real estate and consumer law. If possible, they should not be chosen as the structure of a transaction. And when these deals go bad, they can raise a host of complicated issues and leave the parties subject to a court's subjective determinations of what is equitable.

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1 See, e.g., Mustard v. Sugar Valley Lakes, 7 Kan. App. 2d 340, 642 P.2d 111 (1981).

2 Kansas courts have held that a buyer's equitable interest in property can be pledged as collateral for a traditional mortgage. See, e.g., Garnett State Saving Bank v. Tush, 232 Kan. 447, 657 P.2d 508 (1983) (recognizing that equity interest of buyer may be mortgaged).

3 See K.S.A. 61-3801, et seq. (governing forcible detainer actions); K.S.A. 61-2802(b)(3) (actions in which an interest in real estate is sought to be established cannot be brought under Chapter 61).

4 Stevens v. McDowell, 151 Kan. 316, 319-20, 98 P.2d 410 (1940).

5 Dallam v. Hedrick, 16 Kan. App. 2d 258, 263, 826 P.2d 511 (1990) ("As demonstrated, the proportion of the purchase price paid here was only some 8%. We have been referred to and know of no cases rejecting forfeiture where the proportion of the purchase price paid was so little.").

6 Smith v. Harding, 230 P.3d 461, 2010 Kan. App. Unpub. LEXIS 354 (Kan. Ct. App. 2010) (holding, under the facts of that case, that a payment of $8,207.40 toward a purchase price of $94,000.00 was sufficient to vest buyers with an equitable interest in the property).

7 K.S.A. 61-2911(b) ("If a defendant asserts a counterclaim or cross-claim beyond the scope of the code of civil procedure for limited actions, the case shall be referred by the chief judge for assignment and hearing pursuant to chapter 60 of the Kansas Statutes Annotated, and amendments thereto, assessing the increased docket fee to the defendant.").

8 In contrast, the Kansas legislature has proscribed clear procedures for mortgage foreclosures. See K.S.A. 60-1006 through 60-1010.

9 Barnett v. Oliver, 18 Kan. App. 2d 672, 680, 858 P.2d 1228 (1993).

10 Id.

11 Mustard v. Sugar Valley Lakes, 7 Kan. App. 2d 340, Syl. ¶ 2, 642 P.2d 111 (1981).

12 See, e.g., K.S.A. 50-626(b)(3) ("the willful failure to state a material fact, or the willful concealment, suppression or omission of a material fact"); 50-626(b)(5) ("offering property or services without intent to sell them"); 50-626(b)(5) ("falsely stating, knowingly or with reason to know, that a consumer transaction involves consumer rights, remedies or obligations"); K.S.A. 50-627(b)(5) (including as factor in unconscionability if "the transaction the supplier induced the consumer to enter into was excessively onesided in favor of the supplier").

13 K.S.A. 50-627(b)(5) (including as factor in unconscionability if "the supplier took advantage of the inability of the consumer reasonably to protect the consumer's interests because of the consumer's physical infirmity, ignorance, illiteracy, inability to understand the language of an agreement or similar factor").

14 K.S.A. 50-676.