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Mortgages and Contracts for Deed

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INTRODUCTION

Purchases of farm real estate are commonly financed with a mortgage note or contract for deed. The choice between a mortgage and contract for deed depends on a number of factors, including the rights of the lender or seller in the event of a default by the buyer. This fact sheet explores the legal differences between the use of real property to finance debt through mortgages and contracts for deed in Minnesota. For a discussion on the use of personal property to finance debt, see fact sheet, *Security Interest in Personal Property*.

MORTGAGES

In a typical mortgage transaction, the buyer of the land (also known as the mortgagor) signs a promissory note, which is a promise to pay money, to finance the purchase. For a detailed discussion on promissory notes, see fact sheet, *Contracts, Notes, and Guaranties*. As collateral for the note, the buyer executes a mortgage on the land to the lender (also known as the mortgagee) and the lender pays the seller of the property in full. The buyer obtains a deed to the property, but the lender has a lien—or claim—on the property as documented in the mortgage. The mortgage on the land gives the lender the ability to foreclose on the property if the buyer defaults on the note. For a detailed discussion of the foreclosure process, see fact sheet, *Mortgage Foreclosures.*

Recording

Mortgages are typically recorded in the office of the county recorder where the property is located. Recording gives notice to the public of the mortgage. If the mortgage is not recorded properly, the lender's rights in the property, with respect to other creditors, may be at risk.

Seller as Mortgagee

The mortgagee is not always a third-party lender but the mortgagee may be the seller. If the seller agrees to finance a portion of the sales price by means of a mortgage, the buyer will usually make a down payment on the land and execute a mortgage with the seller for the balance of the purchase price. In such a case, this mortgage is known as a purchase money mortgage. A purchase money mortgage, given by the mortgagor at the same time the mortgagor takes a deed from the seller, has priority over any other claim attaching to the property as a result of his or her ownership in the property. Thus any liens, such as preexisting judgment liens, that relate to the purchaser and attach to the interest the farmer/mortgagor acquires in the land are subordinate to the lien of the mortgage given by the famer/mortgagor to secure payment of the purchase price. This is an exception to the general rule in Minnesota whereby priority of interests in real estate is determined, in the absence of actual knowledge, by the date when the mortgage was recorded.

Legal Title

Under Minnesota law, even though a mortgage is a conveyance, legal title to the mortgaged property is not transferred to the lender. Minnesota is classified as one of the so-called lien theory states. In lien theory states, the mortgagee has no right to possess the property, but merely has the power to sell the property upon completion of a foreclosure.

Rents

As a general rule, a mortgagee is not entitled to the rents derived from mortgaged property. Minnesota law, however, allows a mortgagor of agricultural property to assign the rents to a lender as additional security for the debts secured by the mortgage if the assignment secures an original principal loan of $100,000 or more and the mortgaged property is not the homestead of the farmer/mortgagee. This allows the landlord's lender to make demands on the tenant for rent if the landlord has failed to pay its lender.

Attachments and Fixtures

Issues can arise in the case of agricultural real estate with respect to whether a mortgage covers personal property that has become attached or affixed to the real estate. Whether such personal property (such as silos, grain bins, irrigation systems or dairy parlor equipment) has become so attached or affixed to the real estate as to become part of the real estate and, thus non-removable, is a question that must be determined by a court based on the facts and circumstances of each case. In general, the controlling consideration will be the intentions of the parties, which are determined by evaluating the nature of the property that has become attached to the real estate, the method of attachment, the extent to which the property is tied to the use of the real property and the ability or ease to remove the personal property. If the court determines that the personal property has become attached to the real property, the lien interest of the mortgagee will attach to the personal property even though the personal property is not specifically described in the mortgage. To avoid such issues, the party that financed the improvement should record a fixture filing with the register of deed in the county the real estate is located or the parties to a real estate mortgage should stipulate or carve out in the mortgage whether certain items of personal property will not become part of the real estate subject to the mortgage.

Crops

Closely related to the issue of attached property is the question of whether a mortgage covers crops growing on land that is subject to a real estate mortgage. Crops are personal property, or "goods", and are usually not covered by a mortgage or contract for deed. To obtain a lien on crops, a lender must comply with the provisions of the Uniform Commercial Code with respect to such claims. These requirements are set forth in detail in another fact sheet in this series, *Security Interests in Personal Property*. Unless a lender complies with the rules relating to such liens, a lien against crops cannot be based on the real estate mortgage.

Default

The terms of the mortgage define what constitutes a default. In general, a farmer/mortgagor will be in default by failing to make a mortgage payment, failing to pay property tax or insurance, or failing to use the property in a way specified by the mortgage.

Options upon Default

A mortgage generally provides that upon a default of the mortgagor under the terms of the mortgage, the mortgagee has the option to accelerate the indebtedness, foreclose the

mortgage, acquire the property by credit bidding all or some portion of the debt amount, and sell the mortgaged premises. The procedures in Minnesota for foreclosing a real estate mortgage are discussed in detail in the fact sheet, *Mortgage Foreclosures*.

A mortgage generally includes a provision known as a power of sale clause. This clause allows the mortgagee to foreclose without instituting a lawsuit. Without such a clause in a mortgage, the mortgagee must initiate a lawsuit in order to foreclose its mortgage.

Besides the power of sale, a real estate mortgage will typically include an acceleration clause that provides for the acceleration of the debt in the event of default in payment. Such clauses are contained in both the promissory note and the real estate mortgage that secures the note. A promissory note and a mortgage are separate instruments that are different in nature and purpose. They are enforceable independently of each other on their own terms. Thus, should a lender desire to do so, it may enforce the promissory note independently of the mortgage. However, in doing so, the lender may waive its right to later foreclose its mortgage.

Most mortgages also contain clauses known as due on sale clauses which permit acceleration of the debt in the event the mortgagor sells or transfers an interest in the property without the prior consent of the mortgagee. Such due on sale clauses can be used to limit the farmer/mortgage from having a third party buy the property and assume the loan payments without the consent of the mortgagee/lender.

Extinguishment and Satisfaction

A real estate mortgage is a conveyance as security for the payment of money or the performance of some duty. The conveyance may be nullified upon the payment of money or the performance of the prescribed duty. Thus, when the loan that is secured by a mortgage is paid in full, the interest, or lien, of the lender is extinguished. When the mortgage debt is paid, the mortgage is discharged and the mortgagee has no further interest in the land. At this time, the mortgagor is entitled to a "satisfaction of the mortgage" certificate. This satisfaction certificate should be recorded with the county recorder so that the mortgage will be extinguished in the county records. Until this is done, the recorded mortgage will remain as a cloud on the title.

Divisible Lots; Partial Releases

Occasionally, when a tract of land consisting of divisible lots or parcels is mortgaged to secure a single debt, the mortgagor may sell some of the property to one or more buyers who take title to the land. Unless a partial release of the mortgage is obtained, the buyers of the separate parcels take title to the property subject to the first mortgage. In the absence of an agreement in the mortgage or an agreement between the mortgagor and mortgagee providing for partial releases, the mortgagor has no right to compel the mortgagee to give a partial release of a portion of the real estate from the mortgage.

Farmers-Lender Mediation

Where a mortgage encumbers agricultural real estate, Minnesota's farmer-lender mediation statute generally requires the lender to offer mediation of the debt to the borrower prior to beginning foreclosure proceedings. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires that a creditor seeking to collect a debt affecting agricultural property, including real estate and certain personal property, to offer the borrower the opportunity to mediate a resolution to the debt prior to the lender's

resort to collection action against agricultural property. Such action can include mortgage foreclosure, contract for deed cancellation, seeking possession of personal property or executing a judgment. Where the debt involved has been scheduled by the borrower in a bankruptcy or was involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the lender can seek collection remedies without first offering mediation.

CONTRACTS FOR DEED

Whereas the mortgage is widely used when a lending institution is involved, the contract for deed is frequently used in transactions between private parties. A contract for deed is also known as a "land contract" or "installment land contract." In a contract for deed, the seller, rather than a lending institution, finances the buyer's purchase of the property. The buyer takes immediate possession of the property and agrees to pay the purchase price of the property in monthly or annual installments. The seller retains the legal title to the property until the last payment is made and the contract is fulfilled.

Benefits to the Buyer

This type of arrangement is attractive to buyers who might not otherwise qualify for a traditional loan. In many cases, a buyer will enter into such a contract because, without such an arrangement, they would not be in a financial position to purchase the property. The buyer may also be able to purchase the property with a relatively low down payment. Also, in the event of a default in payments, the buyer need only bring payments current within the time period provided by state law to preserve his or her equity in the property. This is in contrast to most promissory notes containing acceleration clauses, in which upon default the buyer is responsible for the entire amount remaining under the loan. Contracts for deed are also faster and less costly to finalize than traditional mortgages discussed above. Closing costs, origination fees, and application costs are nonexistent.

Risk to the Buyer

A contract for deed does not come without risk for the buyer. Because the seller keeps legal title to property until the contract price is paid in full, the buyer does not become the owner of the property until the buyer completes his or her payment obligations and receives title from the seller. If the buyer defaults on the contract, the buyer runs the risk of losing all of the money that he has paid on the contract.

Benefits to the Seller

At least on the surface, the contract for deed is attractive to seller because it is relatively simple to understand, may provide tax benefits to a seller with a low tax basis in the property, and appears to afford the seller a quick method of canceling the transaction in the event of a default. Contract cancellation procedures are set forth in detail in another fact sheet in this series, *Termination of Contracts for Deed*. In general, if the buyer defaults on an installment, the seller (also known as the *vendor*) can cancel the contract, retake the land, retain the payments made and benefit by any improvements that have been made on the premises by the buyer (also known as the *vendee*). The seller may do this without a foreclosure sale or judicial action. Alternatively, the seller may elect to sue the buyer on the contract.

Risks to the Seller

A contract for deed also places some risk on the seller. The seller runs the risk of not completing ridding itself of the land for many years. If the buyer defaults, the seller will have to take action and may end up taking back the land.

Recording

The buyer must record the contract for deed with the county recorder where the land is located within four months after the contract is signed. Contracts for deed must provide the legal name of the buyer and the buyer's address. Buyers who fail to record the contract within that time are subject to a civil penalty equal to 2 percent of the principal amount of the contract debt.

Contractual Rights and Remedies

The contract for deed is a contract and many of the rights and remedies of the parties are based solely on the provisions contained in it. Provisions such as the time, the place and the amount of payment indicate the continuing contractual relationship between the parties.

The seller agrees to convey the property to the buyer by a specified form of conveyance, usually a warranty deed, once all of the payments are made under the contract, and to furnish an abstract evidencing good title in the seller at the time the contract for deed is executed.

The buyer agrees to pay a purchase price for the property as specified. The buyer also agrees to pay real estate taxes and assessments and to maintain insurance on the premises, including insurance for the benefit of the seller. The buyer also agrees that all buildings and improvements currently on or subsequently added to the land may not be removed, but will remain on the property until the contract is fully performed.

Many other provisions, such as due on sale clauses, contained in a contract for deed are similar to those contained in a mortgage. It may, however, be more common to find a provision in a contract for deed that prohibits the purchaser from prepaying all or any portion of the contract ahead of schedule. The seller may be looking to the contract for deed as a tax planning tool and the contract for deed payments as a source of retirement income and may not desire early payment.

Acceleration clauses are much less common in contracts for deed. There is, however, no legal restriction against including an acceleration clause in a contract for deed. Without an acceleration clause, if a seller wants to forego his or her claim against the land, he or she must bring an action for each installment as it comes due under the contract for deed. The seller cannot accelerate the balance due under the contract.

Nature of the Relationship

Under a contract for deed, the buyer does not own the land but rather acquires an equitable estate in the land. This allows the buyer to occupy and farm the land. Although it is generally considered that the seller retains legal title to the land and is so treated for many purposes, the courts have consistently held that the seller has a security title only and that the buyer is the equitable owner of the property. As such, the relationship is in substance similar to that created by a deed and a mortgage.

Completion of the Contract

When the total purchase price has been paid to the seller, the buyer is entitled to the type of conveyance provided for in the contract. Generally this will require the execution and delivery of a warranty deed to the buyer. When the title to real estate is transferred by a warranty deed, the seller is guaranteeing that he or she has full legal title in the property subject only to those exceptions specifically noted on the deed. In contrast, a quit claim deed transfers all rights in the property of the seller, but provides no guarantee that others do not have prior

claims. Once the purchase price has been paid, the seller must convey legal title to the buyer. If the seller has died or is otherwise unable to make the conveyance, it is the duty of the seller's heirs or representatives to furnish the proper conveyance without any additional cost to the buyer. When the buyer has received the deed from the seller, the buyer should file the deed with the county recorder in the county where the land is located.

Improvements

As noted earlier, improvements a buyer makes on the property may be lost if the buyer defaults on the contract. In the event the buyer plants crops, the crops may likewise be lost if the seller terminates the contract for deed. It is therefore important for a buyer of farmland to make provisions for paying the contract installments during the time that the buyer has growing crops on the land. Otherwise such crops could be forfeited to the seller.

As with the foreclosure of a mortgage, the cancellation of a contract for deed affecting agricultural real estate triggers the provisions of the farmer-lender mediation statute, and may afford the borrower with the right to mediate the debt prior to the lender's starting contract cancellation proceedings.

CONCLUSION

The choice between a mortgage and contract for deed depends on a number of factors, including the rights of the seller in the event of a default by the buyer. A farmer should carefully assess the benefits and risks of both financing methods prior to choosing between a mortgage and a contract for deed.

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