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Policy Recommendations for a Strong State Law on Land Contracts

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Land contracts, also known as contracts for deed, have become increasingly common in recent years and pose unique problems for consumers. In these home purchase transactions, the buyer makes payments directly to the seller over a period of time — often 30 years — and the seller promises to convey legal title to the home only when the full purchase price has been paid. If the buyer defaults at any time, in many states the seller can cancel the contract through a process known as forfeiture, keep all payments, and evict the buyer.

In the 1930s to 1960s, land contracts were systematically targeted to African-American consumers who were excluded from the mortgage market. Now, in the wake of the foreclosure crisis, these contracts are making a resurgence. Large companies with private equity backing are buying up foreclosed homes in bulk, at discount prices, and selling them to would-be homeowners through land contracts.[i] Companies like Harbour Portfolio, Vision Property Management, and Battery Point Financial are just some of the significant players using this business model.[ii]

The National Consumer Law Center has written extensively about the problems with land contracts.[iii] Now, NCLC releases this policy brief to assist state lawmakers and advocates who want to do something to stop predatory land contracts from decimating their communities.

Policy Recommendations

Buyers in land contracts are stuck in a no man's land: the contracts provide them none of the protections of homeownership and none of the legal rights that a tenant would have. This situation allows investors in land contracts to reap a significant windfall at the expense of struggling buyers. In order to change the fundamental unfairness of these transactions, legislation must ensure that until the buyers have all of the rights of homeownership, they should have all of the protections provided to tenants.

The rules outlined below are meant to balance the risks of these transactions between both parties, rather than placing all of the costs and none of the benefits on the buyers. In essence our proposed rules require that the buyer be treated as a tenant until title to the home is transferred. When both parties desire to transfer ownership of a home that is not habitable, with the expectation that the buyer will use sweat equity and financial investment to make it habitable, land contracts are not the appropriate contractual vehicle. Rather the seller should simply transfer ownership of the home at the beginning of the transaction and take a mortgage back to cover the purchase price. With a sale and mortgage back transaction, buyers are better protected: they have all of the protections, as well as the risks, of homeownership.

1. Require the seller in a land contract to make repairs until a deed is conveyed to the tenant-buyer. One of the most predatory aspects of land contracts is that landlord-sellers can draw a stream of income from properties that cannot legally be rented. Unscrupulous sellers often take properties that are uninhabitable and tell the contract buyers that as the new "owners," they have the obligation to make all repairs. Frequently the initial problems include lead paint and inoperable electricity, heating, or water and sewer systems. Often buyers sink tens of thousands of dollars into the homes to make them livable, only to lose all of their investment and be evicted as tenants when they miss a single payment.

This practice violates fundamental state policies requiring landlords to provide safe and habitable homes. It also allows land contract sellers to use the – often illusive – promise of home ownership to shift substantial costs of making the properties habitable and maintaining them in that condition to the less-sophisticated tenant-buyers. Until tenant-buyers have a deed placing legal ownership in their names, they should not be required to maintain the property.

Ensuring that seller-landlords are required to provide and maintain habitable homes would allow municipalities to effectively enforce code requirements and would prevent landlord-sellers from reaping the windfalls from evicting buyers who have made substantial investments on essential repairs. If a landlord-seller fails to make needed repairs, tenant-buyers should have the same rights as any other tenants under state and local laws.

Any provisions in land contracts placing these obligations on the tenant-buyer should be considered illegal and void. Any expenditures made by tenant-buyers to make the property habitable or maintain it should be recoverable as either a set-off against monthly payment obligations or a deduction from any amount owed at the time a contract is terminated. This reform would not prevent "sweat equity" programs in which buyers build their equity by renovating their homes themselves. It would simply require such sales to be structured as true sales, with transfer of a deed, rather than as land contracts that do not pass title to the buyer.

2. Establish a reasonable statutory interest cap, such as a floating rate, 2% above the market index. Some states have already imposed an interest rate cap on land contracts. Tying the cap to the current market rate is the most logical approach. Minnesota, for example, limits the interest rate to 4% above a specified Fannie Mae rate when the contract amount is less than $100,000. Contract sellers may argue that they should be entitled to charge a higher interest rate to account for the risk of default, but on the other hand, the costs of disposition are lower for contract sellers than the costs of foreclosure for a mortgage creditor. Capping the interest rate markup at 2% above the Treasury bill for loans of the same maturity would protect buyers from excessive rates and make successful performance under the contract more likely.

3. Require an independent appraisal. Another unfair practice that is common in land contracts is extreme price gouging on the sale price of the home. Investors pick up a property at tax foreclosure for $1,000 and turn around and sell it on land contract for $20,000, having spent nothing to improve the property or make it habitable. Requiring the seller to obtain an independent appraisal by a licensed appraiser and provide it to the buyer before the execution of the contract would ensure that the buyer has the information to assess whether the purchase price is reasonable and fair.

4. The seller should be required to record the land contract within thirty days. Recording a land contract in the deed records protects contract buyers from having a property sold or mortgaged out from under them without notice. By recording the contract, the buyer's interest

will be visible and protected from other potential buyers, who might otherwise have no notice of the land contract.

5. The seller should be required to pay off any liens before entering into a land contract and should be required to pay the ongoing taxes and prohibited from mortgaging the property during the term of the contract. Because no formal title search is done before a land contract sale, all too often a contract buyer will dutifully make payments for years, only to be notified that the property is in tax foreclosure or mortgage foreclosure due to liens that predate the contract. A buyer in that situation usually can avoid foreclosure only by paying the seller's past-due tax or foreclosure debt – which is often financially impossible. Land contracts are too often worded in a way that confuses the obligations of seller and buyer. States should require the seller to pay the ongoing property taxes until a deed is transferred. If the landlord-seller collects any amount from the contract buyer for homeowner's insurance, it should be required to comply with federal escrow rules under RESPA.

6. If the tenant-buyer defaults, there should be a right to cure and no enforcement of a forfeiture. Without question the most abusive aspect of land contracts is the term that allows a seller to declare upon default that any amounts paid or expended on taxes or repairs are "forfeited" by the defaulting buyer. Land contracts give the illusion that the buyer is building up equity in a home – when in fact, a forfeiture clause allows the seller to keep all that would-be equity. Forfeiture allows the seller to reap a substantial windfall – to keep all of the benefit of the buyer's improvements to the house or upturn in the market, which, in a normal mortgage situation, would belong to the buyer.

Instead of allowing for this punitive contract term, the law should require that upon termination of a contract based on a buyer's default, the tenant-buyer may elect to get back either the difference between the value of the house and the balance owed on the contract (what would be the equity) or any amounts expended on the downpayment, plus repairs and property taxes (which would have been in violation of this state law, because sellers are required to make these expenditures). If the seller has complied with the statutory duty to make repairs, in most cases the buyer will simply be entitled to the return of the downpayment. However, if the value of the property has increased because land values have appreciated, the tenant-buyer should be entitled to recover that value. State law should also provide for a right to cure a default and reinstate the contract within an allowed timeframe.

7. Impose strict penalties to make compliance more likely. Any law regulating land contracts must take into account the fact that many tenant-buyers will not have the resources or legal representation to enforce their rights. Thus, the penalties for noncompliance with the law must be stiff enough to make an impact even if only 1 out of 100 injured tenant-buyers brings a legal action. If a seller fails to comply with the duty to make repairs, the buyer should be able to recover any amounts spent on repairs either by setting this amount off against monthly payments or by recovering those expenses at the time a contract is terminated (even if the tenant-buyer has defaulted). If the seller violates the requirement to obtain an independent appraisal, record the contract, or preserve clear title during the contract term, the penalty should be an automatic return to the buyer of all monies paid or expended in addition to conveying title to the buyer. Such a remedy would incentivize compliance with the law.

8. Make it clear that under state law, land contracts are loans secured by an interest in real property. This provision in state law would make it clear that the protections of the Truth in Lending Act applicable to "residential mortgage loans" would apply to land contracts – in particular, the ban on binding arbitration clauses.

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[i] Alexandra Stevenson, Matthew Goldstein, "Market for Fixer-Uppers Traps Low-Income Buyers," *The New York Times*, Feb. 21, 2016, A1, available at http://www.nytimes.com/2016/02/21/business/dealbook/market-for-fixer-uppers-traps-low-income-buyers.html.

[ii] *Id*.; Alexandra Stevenson & Matthew Goldstein, "Rent-to-Own Homes: A Win-Win for Landlords, a Risk for Struggling Tenants," *The New York Times*, Aug. 21, 2016, available at http://www.nytimes.com/2016/08/22/business/dealbook/rent-to-own-homes-a-win-win-for-landlords-a-risk-for-struggling-tenants.html?_r=0; Heather Perlberg, "Apollo's Push Into a Business that Others Call Predatory," *Bloomberg*, April 7, 2016, available at http://www.bloomberg.com/news/articles/2016-04-07/apollo-s-push-into-a-lending-business-that-others-call-predatory.

[iii] Jeremiah Battle, Jr., Sarah Mancini, Margot Saunders, Odette Williamson, *Toxic Transactions: How Land Installment Contracts Once Again Threaten Communities of Color*, National Consumer Law Center (July 2016), http://www.nclc.org/issues/toxic-transactions-threaten-communities-of-color.html.