CONTRACT FOR DEED

What **Homebuyers** and **Sellers**
Need to Know to Achieve a Successful Outcome

CONTRACT FOR DEED

Is it the right option for me?

This publication is intended to provide advice for both parties in a contract for deed transaction. This publication is not intended to provide legal advice and should not be used as a substitute for professional legal advice. Readers should consult with professionals, such as an attorney and local REALTOR®, for advice concerning specific situations including those contracts for property not located in the State of Minnesota.

CONTRACT FOR DEED
IS IT THE RIGHT OPTION FOR ME?

This handout is intended to assist sellers and buyers using a contract for deed agreement to finance a home purchase. It provides best practices and tips on how to properly execute a contract for deed to better ensure a successful outcome for both parties.

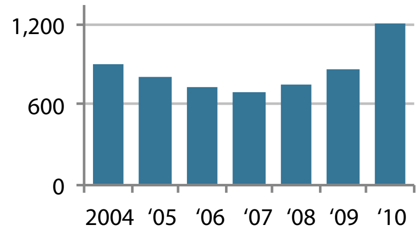
WHAT IS A CONTRACT FOR DEED?

An alternative financing arrangement in which the seller finances the sale of the property rather than a bank or other third-party lender.

A contract for deed is an alternative financing agreement in which the seller finances the sale of the property rather than a lender. As with traditional forms of financing, the buyer takes possession of the home after the closing of the sale. When buying a home through a contract for deed, the homebuyer agrees to pay the seller the purchase price over time with interest in monthly installments.1 Terms of the contracts vary and may include principal and interest, interest only and amortization periods that are negotiated between buyer and seller, typically about 3-5 years, but rarely for terms of 20 years or more. Contract for deed agreements usually include a lump-sum balloon payment, with the full amount due within several years after the purchase of the home. Balloon payments require the buyer to pay the full remaining amount due, for which the buyer will need a mortgage loan. After the homebuyer pays all the payments called for under the contract, the seller is obligated to give the homebuyer a deed to the property. A contract for deed arrangement should not be confused with Rent to Own agreements which allow either party to terminate the agreement without the potential for great financial loss by the renter.

WHEN TO CONSIDER THIS ALTERNATIVE FINANCING TOOL?

Recorded Contract for DEED Sales
in Minnesota



The use of contracts for deed to buy a home is on the rise. The foreclosure crisis has resulted in tighter loan underwriting standards, leading to fewer qualified buyers. At the same time, an increase in bank foreclosures means more homes are for sale at reduced prices. Investors often purchase these homes for cash and then offer them for sale using a contract for deed. Since contract for deed agreements take place without the underwriting criteria set by conventional lenders such as FHA, they are attractive to buyers that are not able to meet these restrictive requirements. Contract for deed agreements are attractive to home sellers because they open up the market to more buyers who, for a number of reasons, cannot find a mortgage-ready buyer to purchase the property.

Buyers and sellers should exercise caution when considering contract for deed financing. If not structured properly, there can be great risks for both buyers and sellers.

Contract for deed financing may seem like the perfect solution to overcome the tough market conditions brought on by the foreclosure crisis. It offers a financing tool for private sellers who are anxious to sell their homes and for homebuyers who are unable to purchase with a mortgage loan. However, buyers and sellers should exercise caution when considering a contract for deed agreement. Regardless of how the contract is structured , there can be great risks for both buyers and sellers. Additionally, buyers should be aware that a contract for deed lacks many of the protections given to borrowers purchasing a home with a conventional mortgage. Still, despite their risks, contracts for deed can be a good fit for some when used wisely. In fact, contracts for deed are used by nonprofits as a means for low and moderate- income homebuyers to purchase homes and revitalize neighborhoods.

1 Myslajek, C. (2009) Risks and Realities of the Contract for Deed. Community Dividend, published by The Federal Reserve Bank of Minneapolis.

WHAT EVERY **BUYER** NEEDS TO KNOW

Before Entering into a Contract for Deed

Contracts for deed offer distinct advantages and disadvantages. Buyers should consider the following before entering into an agreement.

A contract for deed may seem like a great option. However, whether a contract for deed is the best fit depends on individual circumstances. The first questions buyers should ask before purchasing a home with a contract for deed are "Am I ready for home ownership?"; "Is a contract for deed the best option for me?" and "Can this property be purchased on a contract for deed?" A housing counselor can help buyers assess their readiness for home ownership, including if they qualify for a mortgage loan. For buyers who will be mortgage-ready within a relatively short time frame (12- 18 months), renting may be a better option. The Minnesota Home Ownership Center (www.hocmn.org) refers buyers to housing counselors for free in-depth counseling.

ADVANTAGES TO THE BUYER

Low down payment. Some sellers require only a minimal or no down payment.

Homesteading. Purchasing a home by contract for deed gives the buyer the right to homestead and take advantage of certain Property tax benefits such as the market value exclusion and being eligible to apply for the property tax refund.

Mortgage interest deduction. As the legal owner, the buyer can claim mortgage interest deductions and real estate tax on their personal income taxes. Since contracts for deed typically do not require the seller to provide a year-end statement of interest paid, buyers should keep careful records of their payments.

Less stringent financing standards. Since it is the seller's decision, they typically have less stringent underwriting standards than a mortgage loan.

Lower transaction costs. There are no origination fees, points, formal loan applications or high closing costs with a contract for deed. Even if closed by a title company, which is recommended, the costs are much lower than for a mortgage.

Path to home ownership. Structured properly with terms that the buyer can afford, a contract for deed may be a viable path to home ownership for those with credit challenges.

Potential to improve credit score. Making timely payments on the contract can be a way to improve the buyer's credit score. However, this will happen ONLY if the seller reports buyer payments to a credit bureau, which most private sellers do not.

DISADVANTAGES TO THE BUYER

Lacks the protection offered under Minnesota foreclosure laws. If the buyer fails to make a payment or is in default on other conditions of the contract, the seller can cancel the contract and reclaim the property without a foreclosure sale or judicial action.

Financing with a balloon payment. If the buyer is unable to get a loan at the time the balloon payment is due, the seller has the right to cancel the contract with a 60-day notice, take possession of the property and keep any downpayment or other payments to date and any equity that may have accrued.

Seller retains title to the property. This means the seller can continue to burden the property through mortgages and liens. The best way to protect your self is to record the contract with the county recorder immediately after the contract is executed.

Lack of consumer protections. This financing option does not provide the same protections available with standard financing products, leaving open the possibility that unscrupulous sellers will structure the contract with unfavorable terms.

A sale or transfer may bring a new investor with less flexibility. The seller has the unrestricted right to sell his or her interest in the contract. The buyer is typically prohibited from selling their interest in the contract without the seller's consent.

Ineligibility for most first-time homebuyer programs since contract for deed is a form of ownership.

Repair and maintenance issues. The contract may state that the buyer is responsible for property repair and maintenance. However, this is negotiable.

Property taxes and Insurance. Unless otherwise stipulated in the contract, the buyer is responsible for paying property taxes and for obtaining adequate insurance.

Buyer's Checklist
Entering Into a Contract for Deed

Homebuyers purchasing a home with a contract for deed are advised to take the following steps to minimize their risk and to strengthen their chances of successful long-term home ownership.

- **Meet with a housing counselor: It is important to meet with a housing counselor to assess your financial situation.** Counselors can help you determine several things. First, they will help you determine if the house you are buying is affordable based on your financial situation. Second, counselors will review your information to see if you qualify for a conventional or FHA mortgage. If you do, they can then refer you to a loan officer at a bank for conventional financing. Finally, counselors can provide you with a copy of your credit report, which will identify any barriers you need to overcome in order to qualify for a mortgage loan within the time frame of the contract.

- **Have a plan in place on how you are going to pay off the balloon payment when it comes due.**

- **Consider working with an experienced REALTOR® who you trust as your "buyer's agent". They will look out for your interests and negotiate on your behalf.** Buyer's agents are able to assist you with executing the purchase agreement and contract for deed addendum, preparing a market analysis, negotiating a purchase price, contract terms and repair items, setting up the closing and ordering the title work. To find a REALTOR® in your area, go to www.mnrealtor.com.

- **Know the seller's position on extending the contract.** It is important to understand the seller's position on extending the contract before you sign. Many private sellers have other obligations that prevent them from being able to renegotiate the contract. Unless a right to extend is written into the contract, the seller is free to decline an extension request.

- **Ensure the interest rate does not exceed the maximum allowed by law** by calling the Department of Commerce at 651-297-7053 to get a recorded message for the current month's maximum rate.

- **Have an attorney review the contract document to be certain that recommended safeguards are spelled out in the contract for deed and that you understand the agreement.** The attorney will advise you regarding the risks of any underlying mortgages to be sure the seller has the legal right to convey the property. Most first and second mortgages have a <u>due on sale clause</u> that prohibits the sale of the property, including a contract for deed agreement. Make sure your REALTOR® is also familiar with the contract.

- **Get an independent appraisal from an FHA certified appraiser. This is different from a REALTOR® market analysis.** An FHA certified appraiser will not only provide a market value but will also determine if the property will qualify for FHA financing. This is important since FHA is a likely source for buyers who refinance out of a contract for deed.

- **Have the property inspected by a professional inspector; make sure any purchase agreement for the contract for deed is contingent on a 3rd party professional property inspection** even if a "Truth in Sale of Housing" disclosure report is required by the local municipality. A Truth in Sale of Housing report will only list housing code violations. A professional inspection will alert you to major repairs that may be needed in the future that are not necessarily code violations. They can also give you cost estimates for the repairs that can help you negotiate a lower sale price or require that the repairs be completed as a part of the purchase agreement.

- **Purchase title insurance and consider having a title company conduct the closing: The title company will search for any outstanding mortgage or mechanics liens** and if they close the loan will ensure the contract is properly recorded. If there are any issues, the title company will alert you to them and will let you know what items need to be remedied. If issues arise, consult an attorney. A title company cannot provide legal advice.

- **Record the signed and notarized contract for deed.** State law requires the buyer to record the contract (within four months of signing the contract) in the office of the county recorder or registrar of titles in the county in which the property is located. Recording is important to protect your rights to the property and to establish priority over liens that could be placed on the property. In order to be able to record the contract, the contract must include the legal description of the property and buyer and seller must sign the contract before a notary public. Past due property taxes must be paid

- **Purchase homeowners insurance:** Set up a monthly savings plan to ensure you have the funds for next year's policy

- **Create a monthly savings plan** to pay for unforeseen repairs and homeowners insurance, as well as real estate taxes if not included in your payment.

WHAT EVERY **SELLER** NEEDS TO KNOW

Before Entering into a Contract for Deed

Contract for deed financing gives buyers time to repair their credit, which allows them to qualify for a conventional mortgage later on.

Contracts for deed, when structured properly, can be a viable alternative for home builders, rehabbers, developers or private sellers. For example in the Twin Cities metro area, three nonprofit community developers (Greater Metropolitan Housing Corporation, Dayton's Bluff Neighborhood Housing Services, and City of Lakes Community Land Trust) are piloting contract for deed programs to help sell rehabilitated foreclosed and vacant homes. These model contract for deed programs, which employ a number of homebuyer supports and safeguards, are designed as bridge financing for at-risk homebuyers. Hennepin County also allows buyers of tax forfeited properties to purchase them using a contract for deed.

A contract for deed gives buyers time to repair their credit, which may allow them to qualify for a mortgage loan later on. While it is unlikely that an individual home seller has the time or resources to similarly assist at-risk buyers, the experiences of these non-profit programs provide useful information for all sellers using contract for deed agreements.

ADVANTAGES TO THE SELLER

An expanded pool of buyers. In a down real estate market or when credit is tight, sellers can expand the pool of potential buyers to those unable to get a mortgage loan by offering an interest rate and credit terms that conventional lenders are unwilling to offer.

Provides a steady income stream. Sellers who own their property outright can use the contract payments to provide a steady income stream over a long period often at an interest rate higher than other investments.

Easy to cancel the contract. In the case of default by the buyer, the law allows the seller to cancel the contract without a foreclosure sale or judicial action, reclaim the property within 60 days, and retain any payments made by the buyer.

DISADVANTAGES TO THE SELLER

Due on sale clause. Some sellers mistakenly assume that even though they have not paid off their mortgage they can sell their home on a contract for deed and pay off the balance on their mortgage later when the buyer makes the balloon payment. Selling a home on a contract for deed will be a default of any outstanding mortgage and trigger the acceleration clause making the entire loan due and payable immediately, unless the lender approves the sale in writing in advance.

Buyer fails to make monthly payments. If this happens, the seller will have to follow procedures mandated by law to formally cancel the contract and evict the buyers.

Buyer is unable to refinance and make the balloon payment. Even if the buyer has made all the payments on time, there is a risk that the buyer will not be able to refinance when the balloon payment comes due. In this case, the seller will be faced with a difficult and often painful decision to either extend the contract period or cancel the contract and evict the buyer.

During the life of the contract the seller will also be a property manager. The seller needs to be prepared to collect and track monthly payments, verify that property taxes and insurance are kept current, provide a statement of interest paid to the buyer for income tax purposes (if the contract so provides) and monitor the property to make sure it is being properly maintained in order to protect the seller's investment.

Seller's Checklist
Entering Into a Contract for Deed

- **Ensure that the contract for deed document is legal and conforms to Minnesota law.** You can download a blank Uniform Contract for Deed form and other approved contract for deed forms from the Minnesota Department of Commerce website.

- **Use a REALTOR® to assist with the purchase agreement and closing.** It is strongly advised that buyers and sellers each have their own representation.

- **Understand the buyer's situation and refer him or her to the free housing counseling services available in Minnesota if needed.** As the seller, you want the buyer to be successful. The best chance for success comes from a well-educated buyer. The Minnesota Home Ownership Center (www.hocmn.org) refers buyers to housing counselors for free in-depth counseling.

- **Consider escrowing for taxes and insurance.** If the buyer fails to pay taxes and insurance, your property will be at risk. A seller can escrow a portion of the payment to pay annual property taxes and insurance. If not a seller should be listed as an additional insured on the insurance certificate and register with the county the property is located in to request duplicate notice of delinquent real property taxes. Please check with the local county auditor-treasurer's office for specific details about procedures and payment of the filing fee, as provided for under Minnesota Statutes, section 276.041.

- **Make sure the interest rate you are charging does not exceed the maximum allowed by law.** Call the Minnesota Department of Commerce at 651-297-7053 to get a recorded message for the current month's maximum rate.

- **Consider how much assurance you will need that the buyer will be able to refinance within the period set forth in the contract.** It is reasonable to ask for a letter from a lender or housing counselor that includes a timeline and the corrective actions the buyer needs to take to repair his or her credit and qualify for a mortgage. However, it is unlikely that a lender will provide any sort of commitment to make a permanent loan after the contract expires.

- **If still paying on your mortgage** get written permission from the current mortgage holder to avoid the risk that your mortgage will be called due as a result of the contract for deed sale.

- **Clarify responsibilities** between you and the buyer for such things as property tax payments, homeowners insurance, basic maintenance and property upkeep, repairs, periodic inspections and access to the property. If buyer is paying for homeowner's insurance, get a copy and be sure you are listed as loss payee on the policy.

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