Installment Land Contracts: Pitfalls and Cautions

Dale A. Whitman[*]
Visiting Professor of Law
Pepperdine University, Malibu, California
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Introduction. Because of the increasing difficulty of obtaining institutional financing for real estate purchases, it is likely that the provision of purchase-money financing by sellers will increase. In many areas of the nation, the installment land contract is a common vehicle for implementing seller financing. While the installment contract seems superficially attractive, its use carries many risks for both vendors and purchasers that are not raised by the use of an ordinary purchase-money mortgage or deed of trust. This outline discusses many of those risks.

I. **The installment contract**: what is it?

A. The purchaser takes immediate possession.

B. No deed is delivered until the final payment is made (and until then, the purchaser has only "equitable title.")

C. The purchaser typically pays property taxes, insurance, maintenance and repairs, and other operating expenses.

D. A "forfeiture clause" permits the vendor to cancel the contract, retake possession of the property, and retain all payments received if the purchaser defaults.

II. **Enforceability of the forfeiture clause**. From the vendor's viewpoint, the forfeiture clause is the principal advantage of the installment land contract over use of a purchase-money mortgage. The forfeiture clause appears to offer the vendor an extremely easy and inexpensive method of realizing on the real estate security. But whether the clause will be enforced varies greatly around the nation, and may be highly fact-specific within a given jurisdiction.

A. **Statutory regulation**. Some jurisdictions regulate installment contracts by statutes, which usually impose specific notice requirements and grace or cure periods to benefit purchasers. These statutes usually uphold forfeiture if the necessary notices are given and no cure is made. See, e.g., Ariz. Rev. Stat. §§ 33-741 to -749; Iowa Code Ann. §§ 656.1-.7; Mich. Cons.L.Ann. §565.356 et seq; Minn. Stat. Ann. § 559.21; N.D. Cent. Code §§ 32-18-01 to -06; Ohio Rev. Code Ann. §§ 5313.01-.10; Tex. Prop. Code Ann §§ 5.061-.063; Wash. Rev. Code Ann. §§ 61.30.010-.911. Note that even though the statutes legitimize forfeiture, they are not necessarily advantageous to vendors; the Arizona statute, for example, allows a 9 month cure period if more than 50% of the purchase price has been paid. A deed of trust foreclosure could be accomplished in a shorter time.

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Note that most of the statutes permit a cure during a specified period simply by payment of the arrearages – typically, the missed payments plus any interest accrued on them and any costs incurred by the vendor. Hence, any purported acceleration of the debt by the vendor is suspended until the end of the cure period.

B. **Recognition of a right of redemption**. Even in the absence of statutory regulation, courts often recognize the existence of a right of redemption in the purchaser. Since this right cannot last forever, its recognition necessarily requires the court to set a date after which no redemption will be permitted. Thus, it is similar to strict foreclosure of a mortgage. See, e.g., Petersen v. Hartell, 707 P.2d 232 (Cal. 1985); White v. Brousseau, 566 So. 2d 832 (Fla. Dist. Ct. App. 1990); Jenkins v. Wise, 574 P.2d 1337 (Haw. 1978); Nigh v. Hickman, 538 S.W.2d 936 (Mo. Ct. App. 1976); Moore v. Prindle, 394 P.2d 352 (Nev. 1964); Lamberth v. McDaniel, 506 S.E.2d 295 (N.C.App. 1998); Lewis v. Premium Invest. Corp., 568 S.E.2d 361 (S.C. 2002).

The courts recognizing a right of redemption typically do not suspend any purported acceleration by the vendor. Hence, if an acceleration has occurred, the purchaser must pay the entire outstanding balance of the purchase price, often a difficult prospect for a purchaser. In this respect, judicially-recognized redemption differs from the statutory procedures in paragraph II A above.

C. **Recognition of a right of restitution**. A number of courts have recognized that if a forfeiture occurs the result may be to unjustly enrich the vendor, who essentially receives the value of the land in addition to all of the payments previously made on the contract. To avoid this unjust enrichment, a court may order the vendor to refund to the purchaser the payments received, insofar as they exceed the vendor's damages resulting from the breach. See, e.g., Moran v. Holman, 501 P.2d 769 (Alaska 1972); Petersen v. Hartell, 707 P.2d 232 (Cal. 1985); K.M. Young & Assocs. v. Cieslik, 675 P.2d 793 (Haw. Ct. App. 1983); Howard v. Bar Bell Land & Cattle Co., 340 P.2d 103 (Idaho 1959); Randall v. Riel, 465 A.2d 505 (N.H. 1983); Bellon v. Malnar, 808 P.2d 1089 (Utah 1991); Weyher v. Peterson, 399 P.2d 438 (Utah 1965). See Conway, "Equitable Adjustment"' in Real Estate Contract Foreclosures: Victory for the Contract Vendee or Death of Installment Land Contract Financing?, 35 So. Dak. L. Rev. 402 (1990).

It is easy to state this principle in broad terms, but the courts have had little success in implementing it in any consistent manner. Under one approach, the court may measure the vendor's damages as the difference between the contract price and the market value of the property at the date of the breach. See, e.g., Park Valley Corp. v. Bagley, 635 P.2d 65 (Utah 1981). While this approach is widely used in measuring damages for the breach of an earnest money contract, it makes little sense with installment contracts because it fails to take into account the time value of money.

An alternative approach to measurement of the vendor's damages is, in effect, to regard the payments made on the contract as analogous to rent, and to require the vendor to refund any amount received in excess of the property's fair rental value. Of course, in many cases the payments will be roughly equal to fair rent, leaving little or no amount to be refunded.

In Honey v. Henry's Franchise Leasing Corp., 415 P.2d 833 (Cal. 1966), the California Supreme Court held that the two methods of computing restitution were alternatives open to the vendor, who could exercise an election to use one or the other of them. Of course, if real estate prices have generally risen during the term of the contract, the difference-in-value approach above will almost never produce any damages, and will therefore require the vendor to give restitution of much or all of the money received in contract payments. In such an environment, vendors will nearly always choose the second, "rental value," approach.

1. **Limitations on restitution.** Some of the courts that recognize the restitution remedy for purchaser are willing to apply it only if the result of a complete forfeiture would be "unjust," would "shock the conscience" of the court, or would meet some other similar concept of unfairness. See, e.g., Clampitt v. A.M.R. Corp., 706 P.2d 34, 40 (Idaho 1985); Warner v. Rasmussen, 704 P.2d 559 (Utah 1985). Success in meeting this sort of standard is difficult to predict; long and costly litigation may be necessary to determine whether it has been satisfied, making the supposedly quick and cheap remedy of forfeiture just the opposite! Moreover, courts are sometimes very reluctant to find that a forfeiture "shocks the conscience." For example, in Russell v. Richards, 702 P.2d 993 (N.M. 1985), the court refused to order restitution despite the fact that the purchaser would otherwise lose about $50,000 in equity in the property.

D. **Finding a waiver of the duty of strict performance.** Vendors under installment contracts often establish a pattern of accepting late payment from purchasers over a protracted period. When this has occurred, a court may treat it as a waiver of the purchaser's duty of strict timely performance. If so, the court will refuse to recognize the vendor's declaration of forfeiture unless the vendor has first notified the purchaser that timely payment will be required in the future, and has given the purchaser a reasonable time to catch up the payments and come into compliance. See, e.g., Jahnke v. Palomar Financial Corp., 527 P.2d 771 (Ariz.App. 1974); Shirley v. Tolbert, 945 P.2d 567 (Or.App.1997); Bogad v. Wachter, 283 S.W.2d 609 (Mo. 1955).

E. **Treating the installment contract as a mortgage and requiring foreclosure.** A growing number of states have held that installment contracts must be foreclosed in the same manner as mortgages, by judicial sale. In a few cases, this change has been made by statute; see Okla. Stat. Ann. tit. 16, §11A; Fla.Stat. §697.01; Ohio Rev. Code §5313 (requiring judicial foreclosure of residential property if the purchaser has paid more than 20% of the purchase price or has paid on the contract for more than 5 years); Tex. Prop. Code Ann. §§5.091-.092 (requiring power of sale foreclosure of contracts for deed where 40% or more of the price has been paid, the contract is on land that is the purchaser's residence, the land is in a low-income county, and the land is within 200 miles of an international border).

In a number of other states, the courts have held, without statutory prompting, that installment contracts must be foreclosed as mortgages. See Luneke v. Becker, 621 So. 2d 744, 746 (Fla. Dist. Ct. App. 1993); Skendzel v. Marshall, 301 N.E.2d 641 (Ind. 1973); Sebastian v. Floyd, 585 S.W.2d 381 (Ky. 1979); Bean v. Walker, 464 N.Y.S.2d 895 (App. Div. 1983). California reached a similar conclusion, with the provision that the purchaser must have made substantial payments on the contract, in Petersen v. Hartell, 707 P.2d 232 (Cal. 1985). In Colorado the trial court in its discretion may order foreclosure as a mortgage; see Grombone v. Krekel, 754 P.2d 777 (Colo.App. 1988); Paraguay Place-View Trust v. Gray, 981 P.2d 681 (Colo. App. 1999). The Nebraska courts, while not announcing an absolute rule, have indicated a