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Buying Farmland on Installment Contracts

C. D. Clark

South Dakota State University

R. L. Berry

South Dakota State University

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Buying Farmland on Installment Contracts



Economics Department
Agricultural Experiment Station
South Dakota State University, Brookings

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BUYING FARMLAND ON INSTALLMENT CONTRACTS

Chapin D. Clark and Russell L. Berry*

See Your Attorney

An installment land contract can be used to buy and sell land with a low down payment. But this advantage may be offset by unsatisfactory terms that run for many years.

For this reason both buyer and seller should study various ways that the contract can be made and seek advice of their own attorney regarding any land contract they plan to use.

Ten years ago only one out of five South Dakota farms and ranches sold made use of an installment land contract. Now nearly half of the farms and ranches are sold this way. The others are sold for straight cash or with a mortgage. Some also involve trades.

The purpose of this leaflet is to explain the advantages and disadvantages of installment land contracts and to help both buyer and seller avoid certain pitfalls in their use.

An installment land contract is commonly known in South Dakota as contract for deed or land sale

contract. Because some land sale contracts are "earnest money" contracts that call for a lump payment within a few days in exchange for a deed, the term installment land contract will be used here to describe contracts that usually run for several years.

An installment land contract is an agreement between a seller and

*Chapin D. Clark, formerly of the School of Law, University of South Dakota, is associate professor of law at the University of Oregon. Russell L. Berry is associate professor of economics at South Dakota State University. This article is a contribution to North Central Regional Research Project NC-15, "How Young Families Get Established in Farming."

buyer which states that after certain installments on the purchase price are made the title to the land will be transferred by a deed. The seller retains legal title until installments are paid. The agreement also specifies that the buyer shall have possession and use of the land while payments are being made.

Why Use Installment Land Contracts?

The main advantage of an installment land contract is that possession and use of the land can often be secured for as little as 10% of the purchase price. In some cases down payment may not be required—particularly when the transfer is being made in the family.

In contrast to this, a down payment of 30% or more is required when the land is purchased under a mortgage arrangement. The typical range is 40-50%. Thus many farmers and ranchers cannot purchase land under a mortgage arrangement. If they are to farm they must either rent land or buy under a land contract. If land is not available for lease their only alternative may be an installment contract. They then become "owners" not tenants.

The main advantage of the land contract over share rent leasing is that it gives the farmer or rancher much more security of possession or tenure. The law considers that the buyer is the owner of the land. As long as the required payments are made on time the contract buyer knows that he can keep the land.

This is in sharp contrast to most leases which permit the landlord to terminate the lease any year.

Because he is more secure than he would be as a tenant, the contract buyer usually has more freedom to improve the land and buildings. Normally the seller has no objection if the buyer wishes to make improvements. Most buyers do make major improvements or repairs. However, the buyer should be cautious because if he fails to make any of the payments, the seller may terminate the contract and take the land on short notice. When this happens the buyer generally loses all improvements he has made. This is because title under an installment land contract remains with the seller. Thus, while the buyer has more security of tenure than even a cash tenant, he has less than a buyer under a mortgage.

Unlike the share landlord, the seller is usually not concerned about the farmer's choice of crops or how the crops are cared for as long as value of the land is maintained and payments made.

When a farmer or rancher buys land and gives a mortgage he gets title immediately. Even if he fails to make the mortgage payments, as much as 2 years may be required to take possession and title away from him. To foreclose a farm mortgage:

- (1) Court action is required if the buyer demands it;
- (2) The farm must be sold under court supervision;

- (3) The buyer has the right to any proceeds of the sale in excess of the unpaid mortgage debt;
- (4) The buyer has one year in which to redeem the farm or ranch;
- (5) The buyer may keep possession for one year after foreclosure;
- (6) The buyer cannot be sued for any deficiency if the sale does not yield enough to pay the mortgage debt.

In contrast, the contract buyer has little legal protection when he defaults. He may lose the land in as few as 10 days by strict foreclosure proceedings in Court. Unless the default is corrected in the time specified by the Court, the buyer loses possession and all other rights in the land including any payments or improvements made.

Why the difference in legal protection? The main reason is that the contract buyer usually has not earned this protection by putting down enough money to get title. The seller on a "shoestring" sale will not want to deed title to a buyer and give the buyer all the legal protections of a mortgagor. Yet as the years go by the contract buyer will have paid more on the purchase price than many mortgage buyers. For this reason the buyer may prefer a land contract which provides that, when a certain percent or more of the purchase price has been paid, the seller will give the buyer title by deed and accept a mortgage as security for the balance of the price.

Costs Under Land Contracts

Certain land charges must be paid by the farmer or rancher regardless of whether he leases land, is buying it under an installment contract, owns it subject to a mortgage, or owns it clear of debt. These costs are often called the "DIRTI" five: depreciation, interest, repairs, taxes and insurance.

Tenants do not pay these costs directly. They pay them indirectly as rent. The landlord must pay these charges from the rent. He hopes to have enough left over to give him a "fair" return on his investment. In some years the rent may not be enough to cover these costs. Nonetheless, in the long run these costs must be paid out of the rent or what is the same thing, paid indirectly by the tenant.

When a farmer or rancher buys land on the installment plan the contract usually requires that he bear depreciation and pay repairs, taxes, and insurance directly. In addition, he must pay the seller interest on his investment. If there has been no down payment, the sum of these payments should be about the same as rent. As more payments are made the out-of-pocket interest that must be paid becomes less. However, the buyer should remember that he is entitled to interest on the money he has already paid. For example, he could get such interest if he invested his money in bonds rather than land. Hence, even when he has made all the payments and owns the land free of charge the costs of ownership remains much the same. How-

ever, there is this important difference: since he owns the land he does not actually have to pay himself interest. Also depreciation is not a cash cost and repairs can be delayed. Thus he may be able to stand years of poor income easier than he could as a cash tenant.

Advantages, Disadvantages of Installment Land Contracts

Like any other business arrangement the installment land contract has its advantages and disadvantages. Some of these have already been mentioned. These and others may be summarized as follows:

ADVANTAGES TO THE BUYER:

1. Provides greater security of tenure, freedom of operation and improvement than most leases,
2. The down payment is lower than that required by mortgages,
3. It permits earlier "ownership" because of low down payment.

ADVANTAGES TO THE SELLER:

1. Improves chance of selling the farm under favorable conditions,
2. Reduces income taxes by spreading capital gains over several years, if payment during the first year is less than 30% of the sale price,
3. Reduces need for reinvesting funds that occurs under a straight cash sale,
4. Provides a steady source of income as compared to share renting.
5. Provides a quicker and less expensive court procedure in case of default than does mortgage foreclosure,

6. Permits earlier transfer to a son or other relative or friend.

DISADVANTAGES TO THE BUYER:

1. Total cash land charges may be higher than cash rent and less flexible than share rent,
2. Should the buyer default he can lose the farm, including all payments and improvements, more quickly than under a mortgage foreclosure,
3. Fixed payments may be more difficult to meet than share rents.

DISADVANTAGES TO THE SELLER:

1. If the buyer defaults before much is paid on the purchase price, there is some risk of loss to the seller due to cost of foreclosure and waste or deterioration of the property,
2. It is hard for the seller to get his money out of the land in case he needs it.

Things To Look for in Installment Land Contracts

Because purchase of a farm usually involves thousands of dollars and often occurs only once in a lifetime, the buyer should have his lawyer study any proposed contract before it is signed. Likewise the seller should consult his lawyer to make sure that he is properly protected although most printed forms favor the seller—a point the buyer should keep in mind. Some important features of an installment land contract are:

Legal Description of the Land.

An accurate description of the land which is being sold must be includ-

ed in the contract. For agricultural land the description is usually by reference to government survey and includes the range, township and section or portion of section. It is not always safe to rely on legal descriptions in old documents such as a deed. For example, the widening of a road may have taken a strip of land from the edge of the farm, thus the old description is no longer accurate.

Purchase Price and Interest Rate.

Total purchase price, amount paid down, interest rate, and method of paying the balance must all be stated. Frequently, on farm land the buyer wants to make his payments annually or semi-annually to correspond with harvest time or livestock sales. Installments of principal and interest may decline as payments are made or they may remain at a fixed amount—depending upon the desires of the two parties. The fixed or constant payment plan is somewhat more difficult to set up but it may avoid some confusion as to amounts to be paid.

Prepayments. The buyer may inherit some money or otherwise be in a position to pay all or a portion of the principal before it is due. If he does so he will escape paying some interest. Also he may be able to borrow funds and, if permitted, convert to a mortgage at a lower interest rate. But unless the contract permits the buyer to prepay principal, he cannot insist on this right because it deprives the seller of interest without his consent. If prepayments are allowed it is less

confusing if they are required to equal the regular payments and are made on the regular payment dates.

Prepayments will not excuse the buyer from making future payments on dates specified unless this is specifically stated in the contract. Sellers may object to such a statement because it may make them uncertain about future payments—both as to time and amount. Some sellers limit the number of prepayments that can be made in any year. One reason for doing so is that it may sharply increase their income taxes. When less than 30% of the price is received in any one year, federal income tax law permits any capital gain to the seller to be spread over the years in which the payments are received. If the buyer prepays the price before it is due, the seller may have to pay higher income taxes.

Grace Period. Some contracts give the buyer a grace period (usually 30 days) beyond the due date in which to make his payments. Then the buyer will not be in breach of contract for late payment until after the grace period has expired.

Conversion to a Mortgage. Most printed form contracts require the buyer to pay ALL of the purchase price before he is entitled to a deed. However, buyers may want a clause which gives them the right to demand a warranty deed after 50% of the price is paid. To secure the unpaid half of the price, the buyer must promise to give the seller a note secured by a mortgage.

Under a mortgage the buyer has less chance of losing his farm.

Marketable Title. Under an installment land contract the seller does not have to convey legal title by deed until a stated percentage of the price is paid. Therefore the contract should require that the seller present an abstract showing marketable title shortly after the contract is signed if not before. Otherwise, the buyer must make his payments not knowing if he is going to get good title or not. The buyer should immediately take this abstract to his lawyer (not the seller's) for a legal opinion of the title. The abstract is merely a summary of all the documents and records in the courthouse that pertain to this land. Lawyers are trained to analyze the abstract for possible title defects. There is a difference between title to land and a deed. If the seller has good title, it will pass to the buyer on delivery of the deed. But if the seller does not have good title, he cannot transfer good title to the buyer even by a warranty deed. In this case the buyer is probably "buying a lawsuit" either to straighten out the title or to recover his money from the seller.

Place of Payment. It is desirable that the contract specify the place where the payments will be made to avoid confusion as to whether they have been paid. Any reasonable place can be specified.

Escrow. If desired the seller can prepare a warranty deed and place it in escrow with a neutral third party such as a banker with direc-

tions to deliver the deed to the buyer when he has carried out terms of the contract. Terms of the escrow agreement usually require that the buyer make his payments to the escrow agent. When the payments specified in the contract are paid, the escrow agent gives the buyer the deed. If the buyer should default, the deed would be returned to the seller. If the agreement calls for a mortgage and note after certain payments have been made, these should be held by the escrow agent and transferred to the seller at the same time the buyer gets the deed. The escrow arrangement has the advantage that the buyer need not be concerned about the death of the seller. The buyer continues to make his regular payments to the escrow agent who delivers the deed to the buyer when it is due.

Possession of Land. The exact date when the buyer is to gain possession should be stated. This is an important date because the risk of any loss to the property (for example, the barn burns down) in the absence of agreement to the contrary is on the person in possession. That is, the buyer in possession would be legally obligated to continue his contract payments despite any property loss from fire, flooding or other casualty. Thus, the buyer should use insurance to protect himself against such loss.

Management of the Land. When there is little or nothing paid down on the purchase price the contract should specify that the management of the land must be good enough to prevent waste of land or

buildings. Waste occurs when conditions permit more than normal deterioration or normal wear and tear. The contract should also require the seller's consent before removing or selling timber, gravel, or buildings. Such a provision may help keep the buyer from "milking" the land and then allowing it to revert.

New Improvements. If the buyer wants to make new improvements immediately after getting possession, the contract should specify which improvements he may make and, in case of default, how much he will recover of their original cost. Unless the contract specifies that the buyer will be compensated for his improvements in case of default, the seller will have full ownership of the improvements made, and no responsibility to compensate the buyer.

Entry. When the down payment is quite small the contract should specify that the seller may enter the premises at any reasonable time to determine if waste is being permitted or committed, or if buildings, gravel, timber, etc. is being removed or sold contrary to the contract.

Taxes. The contract should clearly specify who is to pay the real estate taxes and special assessments for the year in which the contract was made. Also the contract should specify that the buyer is to pay the taxes and assessments for each succeeding year.

Insurance. The contract should specify:

- (a) What kinds of insurance shall be carried
- (b) What amounts of insurance shall be carried
- (c) Who shall pay the insurance premiums, and
- (d) Who shall receive the payments for loss.

Fire, wind, flood and hail insurance is generally available and the maximum amounts obtainable may be specified. Usually the contract requires the buyer to pay the insurance premium. Unless the contract specifies otherwise, the person in possession will bear the loss under South Dakota law. Usually this is the buyer. To avoid confusion the contract should specify that the buyer is to pay the insurance costs and any proceeds shall be shared between the buyer and seller in direct proportion to their interest in the land as indicated by the amount of the purchase price paid. The contract should specify that the seller's share must be applied to the buyer's debt or used to restore the property.

Assignment. The buyer may, if he wishes, sell, assign or mortgage his interest in the land at any time unless this is specifically prohibited by the contract. Because such an assignment may put into possession a man who will not maintain the property or make the payments, it is reasonable that the seller's interest be protected. This is usually done by requiring the seller's written consent to the sale, assignment, or mortgaging of the property.

Advancement. Suppose the buyer for reasons beyond his control fails to pay any charges against the land such as taxes, special assessments or other charges and fails to provide or pay for property insurance. When this happens it is often to the interest of both parties that the seller pay the charges and collect the payments with interest from the buyer. Therefore an advancement clause which permits the seller to make these payments is a desirable feature of the installment land contract.

Heirs and Assigns. Although the legal rights of either of the two parties are not jeopardized by the death of the other, many land contracts contain a provision which specifies that it is binding upon the administrators, executors, heirs or assigns of either party—thus removing any doubt about the matter.

Default, Forfeiture, and Liquidated Damages. The contract should provide for default. Default occurs whenever the buyer fails to make the payments when due or fails to perform other important conditions required by the contract. When default occurs, the seller, at his option, may declare that the buyer is in default and terminate the contract. Then the buyer forfeits (loses) not only the land and buildings but also all the payments and improvements shall be retained by the seller as liquidated damages for the use of the premises by the buyer. This clause is legally binding despite the fact that the more payments the buyer has made, the

more he is penalized for default. This provision is tempered if the contract contains clauses that permit the buyer to make advance payments and after a certain amount of the principal has been paid, to change from the contract to a note secured by a mortgage. Under these circumstances it is usually possible for the buyer to refinance or sell his equity to another buyer.

Signatures of Parties. The contract binds both parties as soon as they sign it. The signatures must be the full name of each party to the sale. The spouse of the seller should sign. The spouse of the buyer should sign only if the spouse is to have an interest in the property. A lawyer's advice should be sought on the various kinds of "estates" and how legal title can be held.

Acknowledgement and Recordings. The contract should normally be signed and acknowledged before a notary public. Documents which are not acknowledged are not entitled to be recorded in the Register of Deeds office. However, recording is not necessary. The signed contract is valid between the parties even if not acknowledged and recorded. Yet if recorded it gives the world notice that the buyer is the equitable owner of the land. However, possession and use of the land also serves this purpose.

If the buyer defaults, the recorded contract indicates that the buyer still has an equity in the land. This constitutes a "cloud" on the title. To clear the title the defaulting buyer will either have to

give a quitclaim deed to the seller or the contract will have to be foreclosed in court. For these reasons some sellers prefer not to record the contract.

There are two other clauses that frequently appear in land contracts. These are not necessary for a satisfactory installment land contract and hence are listed separately.

“Time is of the Essence” Clause. When this clause appears in a land contract it means that prompt performance of all promises is “of the essence” of the contract. A late performance (for example, a payment is one day late) is thus a total breach of contract. This clause is frequently waived by sellers who accept late payments or excuse

other delays by the buyer. But the buyer should be aware that, in the absence of a waiver, his failure to perform the terms of the contract exactly as written is technically a breach of contract which permits the seller to sue him for strict foreclosure or specific performance.

Acceleration Clause. When this clause is used and the buyer fails to make payments when due or to perform any of his other agreements, the seller may, at his election, declare all future payments now due and payable. For example, if the buyer misses number three of 20 annual payments, the seller can declare all 17 future annual payments now due. This clause is a legal one and can be enforced. For this reason the buyer cannot afford to be careless about meeting the due dates of his payments.