

Key Considerations for Lenders: Land Contracts & Mortgaged Property

By: Kevin Graff, President



Land contracts (contracts for deed) are a common method for buying and selling real property. They can be an effective financing tool that meets the needs of both the buyer and the seller. Effective ownership of the property is transferred to the vendee (buyer) upon execution of the contract, while the vendor (seller) retains legal title until the contract is paid in full.

Is a Land Contract?

A land contract is a seller-financed arrangement in which the buyer makes installment payments directly to the seller. The buyer receives equitable ownership and possession of the property, while the seller retains legal title until the contract is satisfied. Because equitable ownership transfers at execution, a land contract constitutes a conveyance of an interest in real property.

Why Lenders Care About Land-Contract Sales of Mortgaged Property

When a borrower sells mortgaged property on a land contract without lender approval, several risks arise:

- **Due-on-sale clause violation:** Most mortgage documents prohibit transfers without written consent, making the borrower immediately in default.
- **Loss of control over collateral:** The vendee now occupies and controls the property, but the lender has no direct relationship with them unless an assignment is obtained.
- **Increased liquidation complexity:** Without an assignment of the land contract, the lender may need to foreclose on the borrower first before pursuing the vendee.
- **Potential deterioration of collateral:** The lender has limited visibility into the vendee's maintenance, insurance, or tax compliance.
- **Payment risk:** The borrower may rely on the vendee's payments to make their mortgage payments, creating an indirect and less reliable repayment source.

Understanding these risks enables loan officers to protect the Bank's collateral position and minimize unexpected issues in problem credit situations.

Mortgage Covenants and Transfer Restrictions

A standard mortgage document typically includes covenants restricting the mortgagor's ability to convey the property. These covenants often include language such as:

“not to sell, assign, lease, mortgage, convey, or otherwise transfer any legal or equitable interest in all or part of the Property without the prior written consent of Lender; and, without notice to Mortgagor, Lender may deal with any transferee as to its interest in the same manner as with Mortgagor, without in any way discharging the liability of Mortgagor under this Mortgage or the Obligations.”

Essentially, if a borrower sells mortgaged property on a land contract without obtaining prior lender approval, the borrower is in default. Once discovered, this default provides the lender with an opportunity to determine how it will manage the situation.

Lender Approval and the Importance of Assignment

If a borrower informs a loan officer of a potential land-contract sale involving mortgaged property, the loan officer should advise the borrower of the requirement to obtain the lender's approval. Additionally, if the lender approves the sale, the loan officer should require an assignment of the land contract executed by both the vendor (borrower) and the vendee.

The assignment allows the lender to bypass the borrower if the vendee fails to perform and to foreclose directly on the vendee's interest. This step can save the lender significant time, money, and effort in liquidating the property. Without the assignment, the lender would likely need to file a foreclosure action against the borrower before gaining the right to foreclose on the property.

Loan Officer Checklist for Land-Contract Sales

To ensure consistent handling and reduce institutional risk, loan officers should:

- Confirm the mortgage covenants regarding transfers and due-on-sale requirements.
- Inform the borrower that lender approval is required before executing the land contract.
- Obtain a copy of the proposed land contract for review.
- Evaluate the vendee's creditworthiness, if required by policy or prudent practice.
- Confirm insurance coverage and ensure the lender remains properly listed.
- Obtain an assignment of the land contract executed by both vendor and vendee.
- Document the approval in the credit file, including any conditions or monitoring requirements.
- Update collateral records to reflect the assignment and any changes in occupancy.

Institutional Risk Considerations

Unapproved land-contract sales can expose the Bank to several risks, including:

- Impaired collateral value if the vendee fails to maintain the property.
- Difficulty enforcing remedies due to the additional party in possession.
- Potential title complications if the land contract is not properly documented or recorded.
- Regulatory scrutiny if the Bank fails to enforce its own covenants or monitor collateral transfers.

Proactively managing these transactions helps preserve collateral value and demonstrates sound credit administration practices.

The Role of Loan Officers

Loan officers are the first line of defense in identifying and managing land contract risks. Their ability to balance customer relationships with sound collateral protection is critical to the institution's success.

This material is for informational purposes only and does not constitute legal advice. Institutions should consult legal counsel for guidance on specific transactions.