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Richard H. Chused

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Wall Street and “Contracts for Deed”

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On April 18, 2016 the New York Times ran a story on the business page by Alexandra Stevenson and Matthew Goldstein entitled *Wall Street Veterans Bet on Low-Income Home Buyers*. They described how investment companies like Shelter Growth Capital Partners, Battery Point Financial, and Harbour Portfolio Advisors—largely run by those who worked in the mortgage arena during the recent real estate crash—are now buying up houses and “reselling” them to low income buyers under “contracts for deed.” Under such contracts, the sellers (in this case the investment companies) transfer possession of a house under contracts requiring the buyers to make monthly payments equivalent in amounts to those made for mortgages, but at significantly higher interest rates. In addition, contrary to the normal mortgage foreclosure system, the sellers have the right both to keep all of the payments made prior to the default (both interest and principle) and to evict the buyer and regain possession of the property for resale. If buyers have made payments for any length of time these contracts force unreasonable forfeitures of both principle amounts paid and the houses themselves unencumbered by any obligations to the defaulting buyers.

Here’s an example comparing a mortgage and contract for deed transaction using similar money amounts. Suppose Buyer agrees to buy a house for $100,000 from Investment Company entirely financed by a contract for at 10% (not atypical in the contract for deed setting but almost never charged for a mortgage) issued by Investment Company for a period of twenty years.**[1]** In this case the monthly payment (not including property taxes and insurance) would be $965.02. Now suppose Buyer defaults after five years and is evicted. During the five years before the default, Buyer will have paid $47,703.74 in interest and $10,197.56 in principle to Investment Company. Investment Company keeps those funds. Also assume that the value of the house rises by $10,000 to $110,000 during the five-year period before the default. After the buyer is evicted Investment Company will resell the house for that higher price. So Investment Company keeps the paid in principle of $10,197.56 and also gets the benefit of the $10,000 increase in value, for a total $20,197.56.**[2]**

Now let’s see what happens in a mortgage setting. Assume the same money amounts are on the table and a default again occurs after five years. When the Investment Company forecloses after the default, the house is placed on the market or auctioned off. After the sale at the higher value of $110,000 Investment Company is paid the amount of the outstanding balance on the mortgage loan of $89,802.44. Buyer gets the rest—$20,197.56.**[3]**

A little table makes the money pathways very clear:

	Purchase Price	Principle Paid After 5 Yrs.	Increase In Value	$s to Buyer Post Default	$s to Inv. Co. Post Def.
Contract For Deed	$100,000	$10,197.56	$10,000	$0	**$20,197.56**
Mortgage	$100,000	$10,197.56	$10,000	**$20,197.56**	$0

It is easy to see why investors are interested in such deals. They get to have their cake and eat it too. In addition to the income received from charging high interest rates to people ineligible for standard mortgage loans, they also make significant amounts of money every time there is a default. They keep both the paid in loan principle and the increase in value of the house. In fact, the structure of the deal creates an incentive to encourage defaults!

The economic reality of contract for deed transactions is actually that of a loan—but on abusive terms. Mortgage law has a century's long tradition of closing "loopholes" found by investors to cut off the right of borrowers to retain the increase in the value of their houses after default and to gain the full value of mortgage principle payments they made prior to default. In fact some states have adopted statutes requiring that contracts for deed be treated the same as mortgage transactions and others have case law reaching the same result. The investors described in the New York Times article, of course, will only be pursuing contract for deed transactions in states that do not treat them as mortgages.

Controversy about these deals is not new, but it is telling. In a well known set of controversies in Chicago, a local Jesuit community did an amazing research job and discovered that during the 1960s contracts for deed rather than mortgage transactions were routinely being used in black neighborhoods while mortgages were used in white areas. The Jesuits helped organize hundreds of contract buyers to begin a payment strike seeking reformation of their deals into mortgage transactions. Some of the resulting eviction actions led to significant reforms in both the contracts and in the operation of landlord tenant court where eviction actions after defaults on contracts for deed were heard.**[4]**

The claim by those supporting the use of contracts for deed is that they allow those lacking the resources normally required for mortgage borrowing to become home owners. That may turn out to be true for some segment of the contract for deed purchasing community. But the unfair costs imposed on those using the technique, together with the high default rate typically associated with contract for deed sales, makes the purchase of houses this way a bargain with the devil. Two alternatives are much more attractive. One is simply to admit that some people should rent rather than buy. And the other is to develop coherent, well-funded subsidy programs for those with incomes too low to enter the mortgage market. In the meantime investment firms are more than willing to reap the benefits of a forfeiture system allowing them to retain funds traditionally left for the benefit of defaulting buyers.

If contracts for deed, with the new encouragement of investment companies, become commonplace, it would a scandal. State legislatures, or perhaps the Consumer Financial Protection Bureau, need to step in to constrain their use.

Addendum: Not long after the New York Times editorialized about contracts for deed and this blog went online, the Consumer Financial Protection Bureau began investigating ways to limit the use of such deals.**[5]** I hope they decide to take firm action.

[1] In this story I am ignoring the additional possibility that the $100,000 sale price is higher than the amount Investment Company paid for the property. But flipping to make money also occurs when a mortgage rather than a contract for deed is used.

[2] The large amount of interest paid, of course, also is income. But that would have been paid in a mortgage setting as well, at least if the interest rate also was 10%. For comparison purposes I will assume in the next example that the interest also is that high. But note well that interest rates typically are higher in contract for deed sales than in mortgage sales.

[3] The costs of sale after default would be deducted from this amount. While Investment Company probably would absorb such costs in a contract for deed setting, the amounts would be lower. In any case, the basic point is the same. Investment Company keeps both the paid in principle and the increase in value in a contract for deed case, while Buyer gets the bulk of both in a mortgage setting.

[4] The story of the Contract Buyers League in Chicago is beautifully told in Note, *Discriminatory Housing Markets, Racial Unconscionability, and Section 1988: The* Contract Buyers League Case, 80 Yale L.J. 516 (1971). The major reform case is Rosewood v. Fisher, 263 N.E.2d 833 (1970). Its importance in the reform of landlord-tenant law in Illinois is described in Richard H. Chused, *The Roots of Jack Spring v. Little*, 40 John Marshall L. Rev. 395 (2007).

[5] Matthew Goldstein & Alexandra Stevenson, *‘Contract for Deed’ Lending Gets Federal Scrutiny,*The New York Times (May 10, 2016). http://www.nytimes.com/2016/05/11/business/dealbook/contract-for-deed-lending-gets-federal-scrutiny.html