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November 30, 2017

Alternatives to the Traditional Purchase and Sale Agreement

After the real estate market crash of the late 2000s, institutional lenders imposed tight restrictions on lending that prohibited many investors from obtaining the necessary financing to move transactions from due diligence to closing. Investors, needing to become creative to close deals, have responded in the years since by spurning or supplementing such financing with private equity from funds and high net worth individuals. These supplemental sources of financing have helped revitalize real estate markets and submarkets across the United States, but not every investor has equal access to the same amount of capital or identical financial motivations. Before blindly entering into a purchase and sale agreement, landlords, tenants and investors must think beyond that contract and consider alternative strategies to acquire or dispose of real property. Below is part one of a three-part series on alternative acquisition and disposition strategies that offer parties greater flexibility than the typical purchase and sale agreement.

Contract for Deed

A contract for deed, as it is called in Georgia (also known as an installment land contract or land contract), allows the seller to transfer to the purchaser equitable title to the property while retaining legal title to the property as security until the purchaser has paid the purchase price. The purchaser signs a promissory note under which the purchaser agrees to pay the full purchase price in periodic (e.g., monthly) installments in exchange for the purchaser's right to treat the property as its own except for the right to sell the property before the balance of the purchase price is paid. The purchaser can occupy the property, lease a portion or all of the property, and make improvements; but until the purchase price is paid in full, the purchaser cannot sell the property or use it as collateral. In simple terms, the buyer gets the property at closing but legal title is only transferred once the buyer finishes paying the seller.

The structure of a contract for deed offers the purchaser and seller numerous advantages. It is common for the purchaser in a contract for deed to pay a minimal down payment compared to what it would pay in exchange for a loan from a bank. That benefit alone is compelling for purchasers who might not have access to the equity required to obtain traditional financing at the terms they seek. This also saves time for the purchaser, as it does not need to save or accumulate equity to get financing. The lack of traditional financing also allows the purchaser to avoid spending time going through qualification and underwriting. Likewise, if the seller seeks immediate monthly cash flow, it may obtain it weeks or months sooner than the date on which it would receive a lump sum payment for the entire purchase price. If the parties want to accelerate the transfer of legal title without changing the amount of the periodic installment payments, then the parties may agree to the inclusion of an acceleration date on which the purchaser must make a final balloon payment.

In a traditional purchase, legal title is transferred from the seller to the buyer by a deed that is recorded immediately after closing. Recording the deed gives notice to the world that an ownership interest has been transferred. In the case of a contract for deed, the contract itself is recorded. The contract is effective and enforceable upon its full execution, subject to any terms therein that state otherwise. However, recordation is necessary if either party wishes to protect itself from future third-party claims to title.

It is critical that the purchaser to a contract for deed understands the debt obligations of the seller prior to the purchase of the property. As with any purchase, the purchaser should want to be certain that it is taking the property free and clear upon making the balloon or final installment payment. The purchaser should also be certain that its periodic payments match the periodic amounts owed to the seller's creditors. A nightmare scenario would be a purchaser making twenty-five years of installment payments only to discover that a creditor is owed tens of thousands more dollars. Equally as terrible would be if, sometime during the contract term, the seller defaults on a prior note and a lender forecloses or takes the property by deed in lieu of foreclosure. It is also vital that the seller and purchaser understand the tax consequences of entering into a contract for deed and their respective tax-related objectives. This is particularly important if the seller desires to apply the capital gain from the final balloon payment toward the acquisition of a replacement property in a 1031 Tax Deferred Exchange. In such a case, the contract for deed can be drafted such that it is included inside the 1031 account.

Check back for part two of this series on alternative acquisition and disposition strategies, in which I will discuss a classic deal structure that has recently experienced a revival: the sale-leaseback.

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