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Technical Advisory

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Subject: Bond for Deed Transactions and Insurance

Background: Americans love ice cream, with vanilla being the favorite flavor over all others. According to the International Ice Cream Association, of the 1.5 billion gallons produced last year, vanilla was in first place with 30% of the consumption, while chocolate was a distance second place with 10%.

But as everyone who has visited an ice cream shop knows, there are dozens upon dozens of flavors to choose from.

The “plain vanilla” way to purchase a home is to secure a mortgage through a bank or similar lender. But in reality, there are many other ways to purchase a home.

“Bond for deed” is just one of those alternative ways. It is a somewhat unusual arrangement, and presents some unusual insurance issues.

Main Points: Bond for deed transactions are governed by Louisiana statutes (9:2941 et seq.). The concept is not unique to Louisiana. A few other states also utilize the bond for deed contracts, while others have similar procedures known as “Contract for Deed” or “Land Contract.”

A bond for deed transaction is very similar to a “Lease/Purchase” arrangement. However, there are some important differences. In a lease/purchase, a standard real estate sales contract is usually executed, with certain modifications. The closing date is often extended to one year or more, which is the “lease” portion of the contract. The contract will specifically state the agreement by the seller for the buyer to occupy the home prior to closing (during the lease period).

In addition, a rental schedule is agreed to during the lease portion of the contract. At the end of the designated lease term (actually a delayed closing), the sales portion of the contract is then executed.

Often, some portion of the monthly rent is credited towards the sales price during the lease period. However, most lease/purchase agreements include a sizeable non-refundable deposit by the buyer, should the entire contract to purchase not be consummated. In addition, the seller has the option to exercise the completion of the sales transaction under the “specific performance” provision of the contract.

In contrast, a “Lease/Option” agreement gives the buyer the option (or “first refusal”) to purchase the home after the term of the lease has been completed. However, the buyer is not required by contract to purchase the home, as he would be in a lease/purchase contract.

There have been a number of Louisiana court cases arising out of efforts to determine if certain contracts were bond for deed transactions (which would be governed by Louisiana statutes,) or were lease/purchase, or lease/option agreements. Interestingly, in some of the cases, even when the agreement was titled “lease/purchase,” many courts have found them to be in actual fact bond for deed contracts.

Often, the controversy arose over cancellation of the contract by the seller, due to late or defaulted payments by the purchaser. One or the other party was thus seeking resolution based on the provision in the statute requiring 45 day notice to cancel a bond for deed contract (9:2945) – discussed below.

If this sounds a little confusing, consider a judge’s statement in a recent Louisiana case over whether a contract was a lease/option or a bond for deed. (*Bergeron v. Parker*, 964 So.2d 1075 – La. App. 1 Cir., June 2007):

“I take this opportunity and humbly suggest that the Louisiana Legislature should revisit whether we should rescind legislation on bond for deeds. Louisiana has more adequate alternatives that safeguard both the vendor’s and vendee’s rights under Louisiana law; such as, a sale with a mortgage. In my humble opinion, the bond for deed concept has led to nothing but confusion in real estate titles and abuse of various parties.”

What exactly is a bond for deed?

Here is how it is described in Louisiana statutes:

9: §2941. “Bond for deed” defined

A bond for deed is a contract to sell real property, in which the purchase price is to be paid by the buyer to the seller in installments and in which the seller after payment of a stipulated sum agrees to deliver title to the buyer.

In essence, the seller retains ownership of the property until full payment of the contract has been made by the purchaser. It is important to note that a bond for deed contract is not a sales contract in and of itself. Note the phrase, “...agrees to deliver title to the buyer.” That is, when the term of the bond for deed contract has been completed, a separate sales contract must then be executed, in which the deed is officially transferred from the seller to the buyer. (In contrast, a lease/purchase contract already includes the sales mechanism.)

Here is an excerpt from a bond for deed contract:

“It is clearly understood and agreed that this document is not a sale, transfer or conveyance, but only a written agreement to sell, transfer and convey the herein described property in the

future, provided all of the terms, conditions, payments and obligations set forth herein are fully, completely and timely met by the Purchaser.

“The parties further declare that contemporaneously with the final payment, a sale is to be executed by the said Seller in favor of the said Purchaser, in the standard form of a Louisiana cash sale with full warranty of title.

“If, and only if, Purchaser makes all payments prescribed herein and promptly pays all tax assessments and insurance as set forth hereinafter, Seller will at that time execute a sufficient warranty deed, selling and conveying unto Purchaser the following described real property.”

In contrast, under a traditional “plain vanilla” home purchase, the buyer obtains a mortgage from a lender, the seller is paid off in full, and the purchaser is given a deed to the property. The purchaser signs a note with the lender, and pledges the home as collateral against the note through the mortgage document. Thus the seller retains no vested interest in the home anymore. But in the bond for deed transaction, the seller retains the deed throughout the life of the installment contract.

At the same time, however, the bond for deed is not the same as owner financing of a home purchase. In that type of transaction, the owner/seller acts as the mortgagee, but the purchaser is given a deed, as with the plain vanilla type purchase described above.

Why is a bond for deed used?

Some buyers cannot obtain a traditional mortgage, usually due to their credit history, and/or limited funds for a down payment. And while a motivated seller might consider providing owner financing in order to sell his home to a buyer with less than perfect credit, the complexities of foreclosure in the event of buyer default are a disincentive for sellers in such situations.

Under Louisiana statutes, a seller in a bond for deed transaction generally has a much easier task of evicting the delinquent buyer than through traditional foreclosure procedures. Here is the process under the statute:

9:2945. Cancellation of bond for deed upon default

A. If the buyer under a bond for deed contract shall fail to make the payments in accordance with its terms and conditions, the seller, at his option, may have the bond for deed cancelled by proper registry in the conveyance records, provided he has first caused the escrow agent to serve notice upon the buyer, by registered or certified mail, return receipt requested, at his last known address, that unless payment is made as provided in the bond for deed within forty-five days from the mailing date of the notice, the bond for deed shall be cancelled.

B. Where there is no mortgage or privilege existing upon the property, and the buyer shall be in default, the seller shall exercise the right of cancellation in the same manner.

The 45-day notice provision is much more favorable to a seller than the traditional foreclosure procedure, since the seller still holds the deed in a bond for deed arrangement.

How are payments made in a bond for deed transaction?

Louisiana statutes stipulate the following:

9:2943. Method of payment

All payments by the buyers under bond for deed contracts of property then or thereafter burdened with a mortgage or privilege, shall be made to some bank authorized to do business in this state, which shall have been designated as the escrow agent for all parties interested in the contract. The payments shall be distributed by the escrow agent between the seller and the holder of the mortgage or privilege, in such proportion as the secured obligation shall bear to the purchase price in order to insure the buyer an unencumbered title when all payments have been made as provided in the bond for deed contract.

Can a purchaser under a bond for deed claim homestead exemption?

Yes and no. Under the bond for deed statutes (9:2948), a purchaser under a bond for deed was made eligible for homestead exemption. In addition, a second provision was passed in 1995 (as 9:2949), which also provided that a buyer/occupant under a bond for deed was eligible for homestead exemption.

However, conflicting interpretations and opinions arose about whether or not the law was valid and enforceable, which lead to litigation and several opinions by the Louisiana Attorney General. In 1998, 9:2949 was redesigned as Article 477(B) of the Louisiana Civil Code, following a Louisiana Supreme Court ruling. But disagreements continued.

In 2004, a Constitutional amendment passed which expressly eliminated homestead exemption on bond for deed property, except for those granted prior to June 30, 2003. Here is the provision of Article VII, Section 20.(A)(7):

(7) No homestead exemption shall be granted on bond for deed property. However, any homestead exemption granted prior to June 20, 2003 on any property occupied upon the effective date of this Paragraph by a buyer under a bond for deed contract shall remain valid as long as the circumstances giving rise to the exemption at the time the exemption was granted remain applicable.

What if there is a current mortgage on the home a seller wishes to place into a bond for deed arrangement with a buyer?

This can be problematic. At a minimum, the existing mortgage holder must be notified of the pending bond for deed transaction, and agree to certain conditions. More importantly, if the mortgage holder does not agree, they can scuttle the bond for deed transaction by exercising the “due on sale” or “alienation” clause in the mortgage (allowing the mortgagee to “call” the mortgage).

This issue was recently litigated and resolved before the Louisiana Supreme Court, in *Levine v. First National Bank of Commerce*, 948 So.2d 1051 (La. S. Ct. 2006). At issue was whether or not an owner whose home had an existing mortgage could enter into a bond for deed transaction without the mortgage holder invoking the due on sale clause.

The pertinent language on the due on sale clause allowed the mortgage holder to call the mortgage “if all or any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender’s prior written consent.” The fundamental question was whether or not a bond for deed fell within the scope of this provision, given that the seller retains the title/deed during the term of the bond for deed contract.

The Louisiana Supreme Court ruled that a bond for deed did meet the criteria in the due on sale clause, thus allowing the lender holding the seller’s current mortgage to call the loan. This effectively blocks a bond for deed transaction on houses where the lender will not agree.

The Supreme Court ruling was issued December 15, 2006. Subsequently, some parties in the home lending business have opined that this decision will significantly reduce bond for deed transactions in the future. In fact, one article written recently by a prominent title company executive stated that his firm “won’t handle a bond for deed that is wrapping any kind of a due on sale clause. As far as we’re concerned, bond for deed is a dead duck. RIP.”

How should the insurance be arranged on a bond for deed transaction?

The Louisiana statutes on bond for deed do not specify what type of insurance must be procured as a part of the transaction. Therefore, the bond for deed contract itself should be examined.

Following are insurance provisions from two different bond for deed contracts.

Sample #1:

“Fire, hazard, and flood insurance in effect on the date of Act of Bond for Deed shall be handled in the manner set forth in clause _____ below. (Select Option A, B, or C.) Such selection shall be subject to the approval of Insurance Company.

Option A. Insurance Policies are to be transferred and endorsed to Purchaser, at no cost to Purchaser.

Option B. Insurance Policies are to be transferred and endorsed to Purchaser, and Purchaser shall reimburse Seller the prorated premium for the remaining term of the policies.

Option C. Insurance Policies shall be canceled and unearned premiums shall belong to Seller. Purchaser is to provide replacement policies with paid receipt for the year's premium."

Sample #2:

"Purchaser agrees to carry, at Purchaser's expense, fire and extended coverage (minimum \$_____ personal liability) insurance and flood insurance in the minimum amount required.

All necessary insurance policies to protect all parties to be in the names of the respective parties, Seller and Purchaser, as required. Certificates of such insurance shall be delivered to Seller at the time of execution of this agreement.

It is understood and agreed that all insurance proceeds that might be paid under said insurance policies will be distributed between Seller and Purchaser as their respective interest may exist at the time of the payment of such insurance proceeds.

If the existing insurance is continued, Purchaser agrees to review coverage to ascertain the suitability."

Comment: The noticeable differences in the insurance requirements of these two sample bond for deed contracts should illustrate the importance of clearly identifying the required insurance coverages, terms and conditions of each contract. Good E&O documentation is also very important. This is especially true given the statement in Sample #2 about "flood insurance in the minimum amount required."

As to the insurance itself, there are two workable approaches.

Option #1. HO-3 (or HO-2 or HO-5) can be issued in the name of the Purchaser, with the Seller added as an Additional Insured (HO 04 41). This would seem to address the requirement in Sample#2 above that both parties be protected in the insurance.

However, since the Purchaser does not hold the deed, this seems to be in conflict with the ISO Homeowners Eligibility Rule (Rule 104.A.), which requires that the named insured be the owner/occupant. The rule does, however, provide an exception for purchasers under long term contract, as follows:

104.A. 2. To the purchaser-occupant(s) who has entered into a long term installment contract for the purchase of the dwelling and who occupies the dwelling but to whom title does not pass from the seller until all the terms of the installment contract have been satisfied. The seller retains title until completion of the payments and in no way acts as a mortgagee. The seller's

interest in the building and premises liability may be covered using Additional Insured Endorsement – HO 04 41;

It is important to note that the Seller should be added under the HO 04 41, and not the HO 04 10 Additional Interests endorsement. The latter does not afford any specific coverage to the person named as having an additional interest, other than notice of cancellation. In contrast, the HO 04 41 provides the Seller with insured status for Coverages A&B (the house and detached structures), as well as Coverages E&F (premises liability and medical payments).

It is noteworthy that the Homeowners and Mobile Home applications from Louisiana Citizens both include a reference to bond for deed. On page 5 in the HO application, and page 4 in the MH application, under the heading “Additional Interests,” one of the “valid insurable interest types” is a “bond for deed seller.”

In addition to a Homeowners Policy, a Flood Policy should be procured, as required in both sample contracts above. While Sample #2 refers to “*flood insurance in the minimum amount required,*” care should be exercised to offer adequate limits on the building and contents.

Option #2. DWG-3 (or DWG-1 or DWG-2) can be issued in the name of the Seller, or jointly in the names of the Seller and Purchaser, covering their respective interests in the home.

The Seller would also need to have premises liability (since his name is on the deed), either through a DL policy, or through an extension of the homeowners policy on his primary residence. Some markets would prefer to issue an HO 24 70 Additional Residence Rented to Others, viewing the exposure as comparable to a rental home.

The Purchaser would be issued an HO-4.

In addition, a Flood Policy should be procured, as required in both sample contracts above. While Sample #2 refers to “*flood insurance in the minimum amount required,*” care should be exercised to offer adequate limits on the building and contents.

Necessary Action: Circulate this Technical Advisory to all appropriate agency staff.