

Spring 1982

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Recommended Citation

Gena Glaser Trueblood, *Article 9 Governs Assignment of Vendor's Rights under an Installment Land Contract as Security for a Debt--Erickson v. Seattle Trust & Savings Bank (In Re Freeborn)*, 47 Mo. L. REV. (1982)

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CASENOTES

ARTICLE 9 GOVERNS ASSIGNMENT OF VENDOR'S RIGHTS UNDER AN INSTALLMENT LAND CONTRACT AS SECURITY FOR A DEBT

*Erickson v. Seattle Trust & Savings Bank (In re Freeborn)*¹

To secure a loan from the defendant, the vendors under an installment land contract² assigned their interest in the contract and conveyed the land under contract to the defendant.³ The defendant recorded the assignment

1. 94 Wash. 2d 336, 617 P.2d 424 (1980).

2. The installment land contract is a purchase money financing device that is the functional equivalent of a mortgage or deed of trust. See J. CRIBBIT, *PRINCIPLES OF THE LAW OF PROPERTY* 135-36 (2d ed. 1975); G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* § 3.25 (1979); Power, *Land Contracts as Security Devices*, 12 WAYNE L. REV. 391, 393 (1966). The installment land contract also is known as "contract for deed," "long-term land contract," or "bond for deed," *id.*, and it differs from the earnest money contract, which fixes the rights and obligations of the parties from the time an agreement is reached to the date of closing. The installment land contract is the financing method used for the life of the debt; the earnest money contract is in force for a relatively short period while the purchaser obtains financing and examines title. See G. OSBORNE, G. NELSON & D. WHITMAN, *supra*, § 3.25.

When an installment land contract is used as the financing method for a real estate purchase, the purchaser normally takes possession of the real estate when the contract is executed and makes monthly payments of principal and interest. The vendor retains legal title for security purposes until the entire purchase price is paid and executes a deed to the land only when the purchaser makes the final payment. See *id.* Historically, the installment land contract has been used as a mortgage substitute to avoid expensive, time-consuming judicial foreclosure, see Comment, *Installment Contracts for the Sale of Land in Missouri*, 24 MO. L. REV. 240, 244 (1959), or the statutory redemption that may be allowed after a valid foreclosure sale. See G. OSBORNE, G. NELSON & D. WHITMAN, *supra*, § 8.4.

The installment land contract has been popular in low-equity financing. See generally Mixon, *Installment Land Contracts: A Study of Low Income Transactions, With Proposals for Reform and a New Program to Provide Home Ownership in the Inner City*, 7 HOUS. L. REV. 523 (1970).

3. 94 Wash. 2d at 338, 617 P.2d at 426. A companion case, *Patricelli v.*

and conveyance, which was marked "for security purposes only,"⁴ in accordance with Washington real estate recording law.⁵ After the vendors filed a petition in bankruptcy, the bankruptcy court held that the right to receive payments under the installment land contract was personalty; thus, Article 9 of the Uniform Commercial Code governed the transfer of that right to secure a debt. Because the defendant had not perfected its security interest in accordance with Article 9,⁶ the bankruptcy court allowed it no priority to the vendors' rights under the contract and ruled that the trustee could collect the payments.⁷ On appeal to the United States District Court for the Western District of Washington, the district court certified two questions on Washington law to the Washington Supreme Court: (1) is the right to receive payments under an installment land contract personal property,⁸ and (2) is the transfer of that right to secure a debt governed by Article 9?⁹ The Washington Supreme Court answered both questions in the affirmative and agreed with the bankruptcy court.¹⁰

Because it has become more difficult to obtain third-party financing for purchases of real estate during the present inflationary period, use of the vendor-financed installment land contract is increasing.¹¹ This financing method is spreading into states that have used it infrequently.¹² In those states, there is little case law on the characterization of the interests of the vendor and purchaser in the installment land contract and on the legal consequences that may result from that characterization. Decisions from other jurisdictions that have characterized the interests will influence the developing body of case law. Since the rights, obligations, and priorities of subsequent assignees and creditors of the vendor depend on this characterization, the *Freeborn* decision is important for parties that enter transactions with a vendor after he has sold his real estate by installment land contract.

Thurston (*In re Hyak Skiing Corp.*), dealt with an assignment of the contract payments without conveyance of the real estate. *Id.* at 339, 617 P.2d at 426.

4. *Id.* at 339, 617 P.2d at 426. Only one document, a "Deed and Seller's Assignment of Real Estate Contract," was used.

5. WASH. REV. CODE ANN. § 65.04.020, .08.070 (1966).

6. *Id.* §§ 62A.9-101 to -507. See also note 36 *infra*.

7. 94 Wash. 2d at 339, 617 P.2d at 426.

8. *Id.* See notes 13-31 and accompanying text *infra*.

9. 94 Wash. 2d at 341, 617 P.2d at 427. See notes 32-42 and accompanying text *infra*.

10. 94 Wash. 2d at 340, 343, 617 P.2d at 426, 428.

11. See Nelson, *The Use of Installment Land Contracts in Missouri—Courting Clouds on Title*, 33 J. MO. B. 161 (1977).

12. See also Nelson, *supra* note 11, at 167, in which the author advances three reasons for the increasing use of installment land contracts in Missouri: (1) the spillover effect from adjoining states that use them frequently, (2) the risk in low down payment situations that the vendee will not assert his rights if forfeiture is attempted, and (3) the vendor's desire to regain the land on default rather than to lose it at a foreclosure sale.

In answering the first question, *Freeborn* characterized the interest of a vendor under an installment land contract as personalty.¹³ In reaching this decision, the court relied on another Washington case, *Meltzer v. Wendell-West*,¹⁴ which characterized the vendor's interest in an installment land contract as personalty for community property purposes.¹⁵ The *Freeborn* court also relied on *Cascade Security Bank v. Butler*,¹⁶ which held that the interest of an installment land contract purchaser was an interest in real estate within the meaning of the Washington judgment lien statutes.¹⁷ The *Freeborn* court referred to cases catalogued in *Cascade* as "supporting the characterization of a vendee's interest as real property and a vendor's interest as personal property."¹⁸

Characterizing the interests of vendor and purchaser as real or personal property is important in determining the rights of a judgment creditor of either party. In most states, a judgment, from the time it is docketed, becomes a lien on all real property owned by the judgment debtor within the county¹⁹ and gives the creditor the right to foreclose the lien by sale of the real property.²⁰ Thus, when a judgment debtor is a party to an installment land contract, the characterization of his interest in the contract will determine his judgment creditor's rights in the real estate under contract.

The majority of jurisdictions that have decided the issue has characterized the vendor's interest in the contract as realty to which a judgment lien will

13. 94 Wash. 2d at 340-41, 617 P.2d at 426.

14. 7 Wash. App. 90, 497 P.2d 1348 (1972).

15. *Id.* at 95-97, 497 P.2d at 1351-52.

16. 88 Wash. 2d 777, 567 P.2d 631 (1977).

17. *Id.* at 780, 567 P.2d at 632-33. Before the *Cascade* decision, Washington courts had ostensibly followed the doctrine of *Ashford v. Reese*, 132 Wash. 649, 233 P. 29 (1925), that an installment land contract conveyed "no title or interest, either legal or equitable, to the vendee." *Id.* at 650, 233 P. at 30. Washington courts had distinguished *Ashford* frequently, and it was overruled in *Cascade*. 88 Wash. 2d at 784, 567 P.2d at 634.

18. 94 Wash. 2d at 340, 617 P.2d at 427. This characterization of the interests of vendor and purchaser is consistent with the result reached by using the doctrine of equitable conversion. Under that doctrine, the purchaser in equity becomes the equitable owner of the land at the moment a contract for the sale of land is signed; his interest is real property. The vendor retains legal title for security purposes only; his interest is personal property. *See* D. DOBBS, REMEDIES § 2.3 (1973). The *Cascade* court declined to adopt the doctrine on the theory that it "would merely substitute a new set of uncertainty for the confusion that has followed *Ashford*." 88 Wash. 2d at 783, 567 P.2d at 634. The *Freeborn* court did not mention the doctrine of equitable conversion.

19. *See, e.g.*, MO. REV. STAT. § 511.350 (Cum. Supp. 1981).

20. *See* 3 AMERICAN LAW OF PROPERTY § 11.29 (A. Casner ed. 1952) (rights of judgment creditors of vendor and of purchasers of land at execution sales against vendor).

attach;²¹ the doctrine of equitable conversion has not precluded this result.²² The majority premises this characterization on the vendor's retention of legal title. In theory, he has an interest in realty for the amount of the unpaid purchase price.²³

A minority of jurisdictions holds that the vendor's right to receive payments under the contract is personalty²⁴ and requires a judgment creditor to reach that interest by garnishment²⁵ or a creditor's bill in equity.²⁶ The minority view is supported by the doctrine of equitable conversion.²⁷ Also, since most states consider the *purchaser's* interest in the contract to be realty for judgment lien purposes, the minority position reflects the view that the interests of both parties to the contract cannot be realty.²⁸ Legal writers have

21. See, e.g., *Chain O'Mines, Inc. v. Williamson*, 101 Colo. 231, 236, 72 P.2d 265, 267 (1937); *First Sec. Bank v. Rogers*, 91 Idaho 654, 657, 429 P.2d 386, 389 (1967); *Bauermeister v. McDonald*, 124 Neb. 142, 146, 247 N.W. 424, 426 (1932); *Heider v. Dietz*, 234 Or. 105, 116, 380 P.2d 619, 624 (1963); *Reid v. Gorman*, 37 S.D. 314, 321, 158 N.W. 780, 783 (1916); *Heath v. Dodson*, 7 Wash. 2d 667, 673, 110 P.2d 845, 847 (1941).

22. See *Heider v. Dietz*, 234 Or. 105, 114, 380 P.2d 619, 624 (1963) (court recognized doctrine of equitable conversion as legal fiction and noted that doctrine was not universally applicable). The court concluded that "[t]he reasons which persuade equity to hold that equitable conversion applies in devolution cases, or . . . in risk of loss cases, do not necessarily carry over to cases involving the rights of third-party creditors having judgment liens upon real property." *Id.* at 114-15, 380 P.2d at 624.

23. *Lacy, Land Sale Contracts in Bankruptcy*, 21 U.C.L.A. L. REV. 477, 505 (1973).

24. See, e.g., *Cumming v. First Nat'l Bank*, 199 Iowa 667, 669, 202 N.W. 556, 556 (1925); *Jones v. Howard*, 142 Mo. 117, 125, 43 S.W. 635, 636 (1897); *Mueller v. Novelty Dye Works*, 273 Wis. 501, 507, 78 N.W.2d 881, 884 (1956). See generally Note, *Rights of a Judgment Creditor Against a Vendor or Vendee Following an Executory Contract for the Sale of Land*, 43 IOWA L. REV. 366 (1958); *Construction Lien Claimants' Rights Against Purchase Contract Interests: The Role of Equitable Conversion*, 1980 WIS. L. REV. 615.

25. See *Jones v. Howard*, 142 Mo. 117, 125, 43 S.W. 635, 636 (1897) ("It [the vendor's lien for the purchase price] is not subject to sale, but must be reached by garnishment proceedings.").

26. See Note, *supra* note 24, at 373.

27. See 1980 WIS. L. REV., *supra* note 24, at 620-21. For an explanation of equitable conversion, see note 18 *supra*.

28. Each party to the contract has an interest in both realty and personalty. While the vendor has an interest in receiving the contract payments, which is personalty, he also holds legal title to the land, which is realty. The purchaser usually has possession of the land under contract and does have a right to ownership of the land if he pays the purchase price, which is an interest in realty. He also has a personal property interest in the obligation to pay the contract price. Note, 1980 WIS. L. REV., *supra* note 24, at 616 n.8.

sided with the minority view because, not only does it facilitate satisfaction of judgments, it is logically consistent.²⁹

Jurisdictions that have not characterized the interests of vendor and purchaser for all purposes may avoid the tension between the *Freeborn* decision and the majority rule. While the characterization of a contract vendor's interest as personalty is supportable, the adoption of that characterization in a majority rule jurisdiction will result in characterizing the vendor's interest as realty for judgment lien purposes but as personalty for Article 9 purposes. A court in a jurisdiction that follows the majority rule should reconsider that characterization before following *Freeborn*. Since there is room for argument on the proper characterization of the vendor's interest for judgment lien purposes,³⁰ a court considering the adoption of the *Freeborn* position could characterize the vendor's interest as personalty for judgment lien and other purposes. A minority jurisdiction, which already characterizes the vendor's right as personalty, will be able to follow *Freeborn* without being inconsistent.³¹

After deciding that the vendor's right to payment under an installment land contract was personalty, the *Freeborn* court turned to the second question: is the transfer of that right to secure a debt governed by Article 9? Section 9-102(1)(a)³² indicates that for Article 9 to govern a transaction, at least two requirements must be met. First, the parties must intend to create a security interest in the collateral. Second, the collateral must be personal property. The court characterized the transaction between the vendor and the bank as an assignment of contract rights³³ and cited *Hughes v. Russo (In re Equitable Development Corp.)*³⁴ to show that Article 9 governed the assignment. To secure a loan, the *Hughes* vendor-debtor transferred to the lender installment land contracts via a "Security Pledge Agreement."³⁵ The lender promptly recorded the security agreement under real estate recording law, but did not perfect³⁶ the security interest under Article 9 until one month

29. See note 36 *infra*.

30. See notes 27-29 and accompanying text *supra*.

31. One Missouri case, *Jones v. Howard*, 142 Mo. 117, 43 S.W. 635 (1897), has characterized the vendor's interest in an installment land contract as personalty. Missouri, therefore, has precedent for adopting the *Freeborn* position. In *Jones*, the Missouri Supreme Court held that a vendor who had received partial payment of the purchase price of real estate under an installment land contract retained no interest that could be sold at an execution sale, at which only real property can be sold. Instead, the vendor was viewed as having a lien for the remainder of the purchase price, subject to garnishment rather than execution. *Id.* at 125, 43 S.W. at 636.

32. U.C.C. § 9-102(1)(a).

33. 94 Wash. 2d at 341, 617 P.2d at 425-26.

34. 20 U.C.C. REP. SERV. 1349 (S.D. Fla. Dec. 13, 1976).

35. *Id.* at 1350. The land under contract was not conveyed as it was in *Freeborn*.

36. Washington has adopted the 1962 version of Article 9, which requires that a financing statement be filed to perfect a security interest in contract rights, unless the assignment does not transfer a significant part of the contract rights of the

after the vendor-debtor had filed a petition in bankruptcy.³⁷ The bankruptcy court found that the security interest was unperfected when the debtor became insolvent³⁸ and, therefore, relegated the lender to general creditor status.

The *Hughes* court found that the parties met the first requirement of section 9-102(1)(a) because they intended to create a security interest in the contracts.³⁹ The court found that intent present because the agreement was entitled "Security Pledge Agreement," it referred to the lender as the "secured party," and it made explicit reference to compliance with Article 9.⁴⁰ In *Freeborn*, the intent to create a security interest was clear because the agreement contained a recital that the transfer was for security purposes only. The *Hughes* court, like the *Freeborn* court, also found that the parties met the second requirement of section 9-102(1)(a) because it characterized the right to receive contract payments as personal property.⁴¹

assignor. WASH. REV. CODE ANN. § 62A.9-302(1)(e) (1966). Missouri has the same provision. MO. REV. STAT. § 400.9-302(1)(e) (Cum. Supp. 1981). In the 1972 version of Article 9, the term "contract rights" has been deleted and the definition of "accounts" in U.C.C. § 9-106 has been broadened to encompass contract rights.

Classifying the collateral is important because some Article 9 security interests are perfected by taking possession of the collateral, while others are perfected by filing a financing statement. In order to perfect a security interest in personal property, the secured party must first determine how the Article 9 collateral is classified. Classifying the vendor's interest in an installment land contract is difficult because there is no underlying note; the contract is the only document of the transaction. Professor Lacy suggests that the contract is either chattel paper or an instrument and concludes that while chattel paper "seems the better choice, . . . there is no security interest in 'goods.' 'Instrument' applies, literally, because the contract is not a 'security agreement'; at least it does not create a 'security interest' as defined in section 1-201(37)." Lacy, *supra* note 23, at 505 n.11. Another commentator has concluded that a security interest created in the contract is an Article 9 general intangible. See Bowmar, *Real Estate Interests as Security Under the UCC: The Scope of Article Nine*, 12 U.C.C. L. J. 99, 143 (1979).

In general, a security interest in an instrument must be perfected by possession of the collateral. U.C.C. § 9-304(1). A security interest in a general intangible, however, must be perfected by filing a financing statement. U.C.C. §§ 9-302, -305. If a court were to follow Professor Lacy's theory, a security interest in an installment land contract could be perfected only by taking possession of the contract; filing a financing statement would not meet the perfection requirement, and the creditor would be unsecured. If the security interest in the contract were a general intangible, however, the creditor would be unsecured if he took possession of the contract but did not file a financing statement.

37. *Hughes v. Russo (In re Equitable Dev. Corp.)*, 20 U.C.C. REP. SERV. at 1350.

38. *Id.* at 1354-55.

39. *Id.* at 1352.

40. *Id.*

41. See note 10 and accompanying text *supra*.

To buttress its answer to the second question, the *Freeborn* court analogized the transaction between assignee and vendor to the mortgage transaction described in an official comment to section 9-102(3).⁴² The comment indicates that Article 9 governs the pledge of a note secured by a real estate mortgage, if given to secure an obligation to a third party, even though Article 9 does not govern creation of the mortgage. Since the installment land contract vendor holds legal title to the land under contract for security purposes and is functionally the mortgagee of his vendee, this official comment would seem to cover the assignment of the vendor's interest in the contract, if assigned as security to a third party.

Despite the apparent applicability of the official comment to *Freeborn* and the analogous mortgage pledge situation, commentators are split on whether Article 9 governs the assignment of a mortgage as security for a debt.⁴³ This difference of opinion stems from an apparent conflict between two sections of Article 9. Section 9-104(j) states that Article 9 does not apply "to the creation or transfer of an interest in or lien on real estate, including a lease or

42. The *Freeborn* court quoted U.C.C. § 9-102, Official Comment 4 (1972 version), which provides:

The owner of Blackacre borrows \$10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article is not applicable to the creation of the real estate mortgage. Nor is it applicable to a sale of the note by the mortgagee, even though the mortgage continues to secure the note. However, when the mortgagee pledges the note to secure his own obligation to X, this Article applies to the security interest thus created, which is a security interest in an instrument even though the instrument is secured by a real estate mortgage.

Washington's version of Official Comment 4 is identical to the first two sentences quoted above, but it then states, "However, when the mortgagee in turn pledges this note and mortgage to secure his own obligation to X, this Article is applicable to the security interest thus created in the note and the mortgage." WASH. REV. CODE ANN. § 62A.9-102, Official Comment 4 (1966). While there is little difference in the language of the two versions, the 1972 version relied on by the court seems to exempt the mortgage from coverage while applying Article 9 to the note.

43. See Coogan, Kripke & Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARV. L. REV. 229 (1965). Influential sponsors of the U.C.C. replied to the contention of title companies that the pledge of a mortgage was a Code transaction falling within the category of a general intangible. The commentators stated that the "clear intent of section 9-104(j) to exclude transfers of liens on real estate would be completely nullified if the argument were accepted that the lien, as a form of wealth, is personal property, a security interest in which is subject to article 9." *Id.* at 270-71. They concluded that "[t]here is, in our opinion, no danger that a court could read the statute in any such fashion." *Id.* at 271. Another commentator, writing at the same time, felt that Article 9 did apply to "security transfers of instruments or writings which evidence or embody interests in real property." G. GILMORE, 1 SECURITY INTERESTS IN PERSONAL PROPERTY 311 (1965).

rents thereunder"; section 9-102(3) provides that the "application of this Article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this Article does not apply." Some commentators believe that section 9-104(j) controls over section 9-102(3) and the explanatory official comment. In other words, a mortgage is an interest in or lien on real estate; therefore, Article 9 does not govern the transfer of that interest as security for a debt.⁴⁴ The court's answer to the first question, which held the vendor's interest to be personal property, however, made it unnecessary to resolve this controversy because Article 9 expressly includes any transfer of personalty intended to create a security interest.⁴⁵

The *Freeborn* decision provides a warning to lenders who secure loans with a vendor's interest in an installment land contract. If the land is conveyed, the deed, of course, must be recorded according to local real estate law. It also would be wise to record the assignment.⁴⁶ But, of most concern, the security interest thus created should be perfected in accordance with Article 9 because a court may characterize the vendor's right to receive payments as personalty, a security interest which must be perfected under Article 9. In order to be protected in any situation, the lender should take possession of the contract and file a financing statement in all appropriate offices. Thus, a prudent lender must perfect his security interest in the contract as both a real and personal property security device to have priority over subsequent bona fide purchasers.

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44. The trend seems to be toward separate treatment of the note and the underlying security embodied by the mortgage, particularly after the adoption in 1966 of the modified Official Comment 4. If a mortgage were the only evidence of the obligation as well as a lien on the real estate, then it would seem that the mortgage arguably could fall within the Code. This is usually the situation with the installment land contract. See Comment, *An Article Nine Scope Problem—Mortgages, Leases, and Rents as Collateral*, 47 U. COLO. L. REV. 449, 455 (1976).

45. U.C.C. § 9-102(1)(a).

46. See G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 2, § 5.34 (comprehensive discussion of risks assignee of note secured by mortgage takes when he does not record assignment).