CONTRACTS—A Real Estate Installment Contract Conveying a Farm Via a Single Deed Is Not Divisible When the Parties Have Allocated Separate Purchase Prices to the Residence and the Farmland to Take Advantage of Tax Laws, Even Though the Buyers Have Fully Paid for the Residence—*May v. Oakley*, 407 N.W.2d 569 (Iowa 1987).

On September 28, 1979, Donald and Irene Oakley contracted to buy John and Edith May's 320-acre Iowa farm for $338,000.[1] The contract specified that $50,000 of the total represented the purchase price of the residence[2] and that the balance of $288,000 represented the purchase price of the farmland.[3]

The sellers and the buyers agreed that the contract allocated separate purchase prices for the residence and the farmland to avoid capital gains tax.[4] The Oakleys wanted to secure a tax-free exchange of their Illinois farm residence for the Iowa farm home they were buying,[5] while the Mays desired to take advantage of a once-in-a-lifetime exclusion on the sale of a residence.[6] To obtain the tax advantages, it was imperative that the value of the

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1. May v. Oakley, 407 N.W.2d 569, 569 (Iowa 1987). The farm was located in Davis County, Iowa. *Id.*

2. *Id.* The contract described the residence as "constituting two acres more or less . . . to include the actual residence structure, yard, and circle driveway." App. II at 7, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563) [hereinafter "App. II"].

3. May v. Oakley, 407 N.W.2d at 569. The actual wording of the contract read as follows:

> 1. The TOTAL PURCHASE PRICE for the above described real estate, which includes separately both Sellers' residence portion and farm portion, is the sum of Three Hundred Thirty-eight Thousand Dollars ($338,000.00). Of said total sum the amount of Fifty Thousand Dollars ($50,000.00) is allocated as total purchase price for the residence and the amount of Two Hundred Eighty-eight Thousand Dollars ($288,000.00) is allocated as total purchase price for the sale of the farm . . . .

Id. at 570.

4. *Id.*

5. *Id.* The Internal Revenue Code allowed a tax-free exchange of residential property if the taxpayer's adjusted sales price of the former residence did not exceed the cost of buying the new residence. I.R.C. § 1034(a) (1982).

6. May v. Oakley, 407 N.W.2d at 570. A person fifty-five years old or older may elect to exclude the gain from the sale of his principal residence. I.R.C. § 121(a) (1982). However, this is a once-in-a-lifetime exclusion. I.R.C. § 121(b)(2) (1982).

> In the case of property only a portion of which . . . has been owned and used by the taxpayer as his principal residence . . . this section shall apply with respect to so much of the gain from the sale or exchange of such property as is determined, under regulations prescribed by the Secretary . . . .

I.R.C. § 121(d)(5) (1982). "Where part of the property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section." May v. Oakley, 407 N.W.2d at 570, citing Treas. Reg. § 1.1034.2(c)(3)(ii) (1986).

residence be determined and allocated in the contract.[7]

In accordance with the contract terms, the Oakleys paid the Mays $50,000 by October 1, 1979,[8] and this money was applied solely toward the purchase price of the residence.[9] Though they had paid the Mays the full price for the residence in cash,[10] the Oakleys never requested a separate abstract and deed for the estimated two-acre parcel.[11] Additionally, the contract did not contain a separate legal description for the residence portion of the farm.[12]

At the January 15, 1980, closing, the Oakleys paid the Mays $50,800. This sum was designated as a downpayment on the farmland portion of the real estate.[13] The Oakleys also assumed the Mays' Farmers Home Administration mortgage,[14] which identified both the residence and the farmland portions of the farm as security.[15]

A warranty deed conveying the 320 acres was then executed by the Mays in favor of the Oakleys and was placed in the custody of an escrow agent.[16] The contract expressly declared that even though separate purchase prices were allocated to the residence and the farmland, only one deed—conveying the entire 320 acres—would be transferred to the Oakleys

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7. *Id.*, citing Treas. Reg. § 1.1034(c)(3)(ii) (1986).

8. App. I at 30, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563) [hereinafter "App. I"].

9. The contract stated that the Oakleys were required to pay $10,000 as a "downpayment upon the purchase price of the residence portion of the above described real estate" at the time the contract was signed; then, they were required to pay $40,000 by October 1, 1979, "as the balance of the purchase price of said residence." May v. Oakley, 407 N.W.2d at 570.

10. *Id.* at 571.

11. *Id.* Traditionally, if a real estate contract allocates separate purchase prices to the residence and the farmland, and the buyers are required to pay in full for one parcel before paying on the other, the contract will require the sellers to deliver a separate deed and abstract for the first tract when it has been paid for. Interview with Orville W. Bloethe, Chairman, Taxation Committee, Iowa State Bar Association, in Des Moines, Iowa (Sept. 18, 1987) [hereinafter "Bloethe Interview"].

12. May v. Oakley, 407 N.W.2d at 571. In one part of the contract, the residence was described "as being the dwelling house, garden and yard adjacent thereto, which is partially bounded by a fence and a roadway . . . ." *Id.* Later in the contract it was referred to as "two acres more or less" and included "the actual residence structure, yard, and circle driveway." *Id.* At the trial Mrs. Oakley said that the residence "would include from the side yard back behind the machine shed and just about cut that barn in half." *Id.*

13. App. I, *supra* note 8, at 30-31. The contract stated: "On January 15, 1980, Buyers shall pay to Sellers the sum of Fifty Thousand Eight Hundred Dollars ($50,800.00) as a downpayment on the far portion of the above described premises." App. II, *supra* note 2, at 5.

14. May v. Oakley, 407 N.W.2d at 569. The contract stated, in pertinent part, that "Buyers shall assume Sellers' mortgage given to and in favor of Farmers Home Administration of the United States of America, mortgagee. Buyers shall assume the principal amount of Forty-two Thousand Five Hundred Sixty Dollars ($42,560.00) of said mortgage." App. II, *supra* note 2, at 5.

15. App. I, *supra* note 8, at 34.

16. *Id.* at 7.

upon the completion of all installment payments.[17]

Beginning on March 1, 1981, the Oakleys began making annual payments of $20,570 to the Mays.[18] These annual payments were made through 1984.[19] However, Don Oakley died in January, 1985.[20] Because of her husband's death and compounding financial problems,[21] Irene Oakley did not pay the 1985 contract installment.[22]

Having failed to persuade the Mays to reduce the annual payments,[23] Irene Oakley requested a separate deed for the residence.[24] The Mays refused this request and immediately sent Irene a letter which gave her the contractually required ninety-day notice of intent to serve notice to forfeit the contract if the delinquent payment and taxes were not paid. In response to Irene's request to furnish a separate deed for the residence, the Mays filed an action in the Davis County District Court to obtain a declaratory judgment affirming their right to withhold such a deed.[25]

On August 7, 1985, the Mays formally served Irene with a thirty-day notice of forfeiture.[26] Two days later Irene filed a petition in equity seeking to have the formal forfeiture notice enjoined with respect to the residence.[27] Additionally, she asked that a deed be conveyed to her for the residence

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17. May v. Oakley, 407 N.W.2d at 571.

18. App. I, *supra* note 8, at 5. The annual payments were $20,569.56 and were to continue for twenty years. *Id.*

19. *Id.* at 40.

20. *Id.* at 112. Donald Oakley was fifty-two years old when he died. *Id.* There is no question that Donald Oakley took care of all the business affairs of the couple. *Id.* at 16-17. The record is clear that at the time of contracting, for example, Irene merely signed where she was instructed to sign. *Id.* at 17. She did not read the contract or other documents nor did she understand what was meant by a tax-free exchange of property. *Id.* at 16-17.

21. The January 1, 1985, payment ($2,674.23) to the Farmers Home Administration was not made, and there were unpaid real estate taxes totaling $4,845.10. *Id.* at 41.

22. *Id.* Mrs. Oakley received $24,000 from her farm tenant on February 28, 1985; however, she decided not to pay the sellers the $20,569 which was due on the next day. *Id.* at 9. At the trial she implied that she did not make the payment because she felt she was going to lose the farm the following year. *Id.* At the time of this default, the Oakleys had paid $224,862 toward the purchase of the farm. Brief for Appellants at 20, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563). However, they still owed the Mays over $205,000. Brief for Appellees at 35, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).

23. App. II, *supra* note 2, at 16. After the March 1 default, Irene's attorney requested that the sellers agree to modify the contract by reducing the purchase price from the original $1,056.00/per acre to $800.00/per acre. Brief for Appellees at 8-9, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563). The Mays refused to accept this modification. *Id.* at 9.

24. May v. Oakley, 407 N.W.2d at 569.

25. App. II, *supra* note 2, at 18-19.

26. *Id.* at 8. Iowa law requires that a vendor provide a vendee with a thirty-day notice of forfeiture. IOWA CODE § 656.2 (1985).

27. May v. Oakley, 407 N.W.2d at 570. Irene Oakley then filed an answer which included a request that she be granted a general warranty deed conveying the residence portion of the farm to her as a matter of equity. Brief for Appellants at 3, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).

portion of the farm.[28] The district court granted a temporary injunction enjoining the forfeiture and consolidated the two actions.[29]

The trial court held that Irene was not entitled to a separate deed for the residence and denied injunctive relief in the forfeiture proceedings.[30]

On appeal, the Iowa Court of Appeals reversed the district court and held that Irene was entitled to a warranty deed for the residence.[31] Judge Sackett reasoned that "[f]orfeitures are not favored in law and courts will so construe contracts as to avoid them if possible."[32]

The court of appeals rejected the Mays' argument that the residence served as security for the contract.[33] The court held that since the contract did not expressly declare the residence as security for the farmland, an implied security interest should not be recognized.[34] The court was influenced by the fact that the Oakleys were not required to maintain insurance on the house, since they had paid for it in full.[35] On the other hand, the contract did obligate the Oakleys to insure the outbuildings.[36]

Since the two tracts were priced separately in order for both parties to secure tax advantages,[37] the court held that the contract was divisible.[38] The court ruled that a legal description of the estimated two-acre tract could be

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28. Oakley v. May, No. 85-1563, slip op. at 5 (Iowa Ct. App. Dec. 23, 1986) [hereinafter "Oakley v. May, slip op."].

29. *Id.*

30. May v. Oakley, 407 N.W.2d at 570.

31. *Id.*

32. Oakley v. May, slip op., *supra* note 28, at 6.

33. *Id.* at 9.

34. *Id.* The court stated, "Absent an express provision in the contract, we refuse to extend the contract to provide the residential tract stands as security for the unpaid balance on the farm acres." *Id.*

35. *Id.* The contract stated, "Whereas Buyers have paid for the total purchase price of the residence, said Buyers need not maintain insurance coverage on said residence." App. II, *supra* note 2, at 6.

36. The contract stated that "Buyers agree to keep the farm buildings and improvements upon said premises insured against loss . . . for a total sum of $16,800 or the balance owing under this contract, whichever is less." *Id.*

37. *See supra* notes 5-6 and accompanying text.

38. May v. Oakley, 407 N.W.2d 571. (*See also* Oakley v. May, slip op., *supra* note 28, at 7.) The court stated:

> As a general rule, it may be said that a contract is entire, when, by its terms, nature, and purpose, it contemplates and intends that each and all of its parts and the consideration shall be common, each to the other, and 'interdependent.' On the other hand, it is the general rule that a severable contract is one in its nature and purpose susceptible of division and apportionment. The question whether a given contract is entire or separable is very largely one of intention, which intention is to be determined from the language the parties have used, and the subject matter of the agreement. The divisibility of the subject matter or the consideration is not necessarily conclusive, though of aid, in arriving at the intention.

Id. (citing Sturtevant Co. v. LeMars Gas Co., 188 Iowa 584, 591, 176 N.W. 338, 341 (1920) (quoting Timber Co. v. Windmill & Pump Co., 135 Iowa 308, 310 (1907))).

ascertained and that, as a matter of equity, a deed should be conveyed to Irene Oakley.[39] Additionally, the court directed that the sellers deliver a deed to Irene that was "free of any lien created on the residential portion by the existence of a mortgage with Farmers Home Administration . . . ."[40]

The Iowa Supreme Court, sitting en banc, vacated the court of appeals decision and affirmed the district court ruling.[41] The court stated that the facts did not support the buyers' argument that the contract was intended to be divisible.[42] Rather, the only reason for allocating separate purchase prices to the residence and the farmland was to secure tax savings for both parties.[43] Though the majority conceded that allocating different purchase prices to the residence and the farmland gave some support to the contention that the contract was divisible, it held that the contract, when viewed in its entirety, "was not intended to be divisible."[44]

The court believed that Irene's failure to request a separate deed for the residence until after she had been notified of the Mays' intent to forfeit the contract was evidence that the sale was for only one parcel.[45] The majority cited *Home Federal Savings & Loan Association v. Campney*[46] for the proposition that "[w]e must give effect to the intent of the parties at the time the contract was executed, not an intent subsequently developed."[47]

In *Home Federal Savings & Loan Association*, the buyers of a house failed to read the terms of a mortgage which gave the savings and loan association the right to collect the outstanding balance if the property was sold.[48] When the Campneys sold the house on contract, the financial institution foreclosed on the property to collect the outstanding balance.[49] The buyers claimed that their reasonable expectations (*i.e.*, to be allowed to pay the mortgage off over the full term) should be given effect since the "due on sale" clause was unconscionable and was contained within the boiler plate language of a contract of adhesion.[50] The Iowa Supreme Court disagreed, stating that the doctrine of reasonable expectations applies only if the contested clause: "(1) is bizarre or oppressive (2) eviscerates terms explicitly agreed to, or (3) eliminates the dominant purpose of the transaction."[51] The

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39. Oakley v. May, slip op., *supra* note 28, at 10.
40. May v. Oakley, 407 N.W.2d at 570.
41. *Id.* at 572.
42. *Id.* at 571.
43. *Id.* at 570. *See supra* notes 5-6 and accompanying text.
44. *Id.* at 571.
45. *Id.*
46. Home Fed. Sav. & Loan Ass'n v. Campney, 357 N.W.2d 613 (Iowa 1984).
47. May v. Oakley, 407 N.W.2d at 571 (citing Home Fed. Sav. & Loan Ass'n v. Campney, 357 N.W.2d at 617).
48. Home Fed. Sav. & Loan Ass'n v. Campney, 357 N.W.2d at 616.
49. *Id.* The savings and loan association had offered to renegotiate the interest rate with the mortgagors; however, the mortgagors refused this option. *Id.*
50. *Id.* at 618.
51. *Id.* at 620.

court also noted that even if a person fails to read a contract of adhesion, he assents to all the reasonable or standard terms of such an agreement.[52]

In the present case the court noted that the May-Oakley contract stipulated that only one deed, conveying the entire 320 acres, was to be delivered to the buyers.[53] The following contractual language was significant: "It is hereby agreed and understood that although the aforesaid acreages are divisible by nature, and divisible by purchase allocation amounts, a *single deed* shall be delivered as aforesaid in conveyance of both said tracts, and in satisfaction of the terms and conditions of this contract."[54]

The majority believed the absence of a legal or even an accurate description of the residence property in the contract provided strong evidence that the parties never intended that separate deeds be conveyed under any circumstances.[55]

Irene Oakley argued that the contract was ambiguous since there was no express provision made for the parties' rights in the event the purchase price of the residence was fully paid but the farmland portion of the contract went into default.[56] She claimed that since the residential purchase price had been fully paid in 1979 and the Mays reported the sale of the residence on their 1979 tax forms, equity required that she obtain a separate deed to the house.[57]

The Mays, however, argued that the contract contained clear language as to their rights in the event the contract was breached.[58] The contract stated that if the Oakleys failed "to perform this agreement in *any* respect . . . Sellers may declare this contract forfeited . . . and *all* payments made and improvements made on *said premises* shall be forfeited as by law allowed . . . ."[59] The only legal description of the "said premises" covered the entire 320 acres.[60] The Mays emphasized that they retained a security interest in the entire 320 acres, not just the farmland.[61] The Iowa Supreme Court agreed with the Iowa Court of Appeals that "equity abhors a forfeiture," but quoted *Miller v. American Wonderlands, Inc.*,[62] for the proposition that equity "does not abhor a forfeiture enough to override established legal

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52. *Id.* at 618.
53. May v. Oakley, 407 N.W.2d at 571.
54. *Id.* (emphasis by court).
55. *Id.* at 572. *See supra* note 12.
56. Brief for Appellants at 11, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).
57. *Id.* at 19.
58. Brief for Appellees at 11, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).
59. App. II, *supra* note 2, at 8 (emphasis added).
60. *Id.* at 7.
61. Brief for Appellees at 11, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).
62. Miller v. American Wonderlands, Inc., 275 N.W.2d 399 (Iowa 1979). In this case a forfeiture clause was enforced on a $30,000 real estate contract after the seller had paid approximately $673 in delinquent real estate taxes and served notice of forfeiture on the buyer. The buyer reimbursed the seller for the unpaid taxes but refused to pay the seller's expenses of $10.48. *Id.* at 400-01.

principles."[63]

Justice Carter dissented, arguing that the contract divided the farm into two parcels and listed separate consideration for each tract.[64] Since the Oakleys had fully paid for the residence, Justice Carter maintained that Irene should be declared its equitable owner.[65] Even though the contract called for delivery of only one deed for the entire property, the dissent argued that "[t]he rights of the parties should be determined by a court of equity in accordance with the property interest granted by the contract rather than the procedures provided to implement those interests."[66] The dissent was not convinced that lack of a legal description was a barrier to a determination of the precise boundaries of the residence.[67]

The decision of the Iowa Supreme Court is significant.[68] The fact that the parties allocated separate purchase prices to the residence and the farmland to obtain tax benefits did not make the contract divisible.[69] It is not uncommon for the contract of sale for a farm to be drawn in the form of the May-Oakley contract with separate "purchase prices" allocated to the residence and the farmland.[70] Traditionally, however, such contracts state that a separate deed and abstract will be delivered for each parcel upon full payment for the respective tract.[71] The record in this case does not reveal why the buyers did not demand a deed to the residence at the time they paid for it.

Though the final judgment appeared to be contrary to the principles of equity relied on by the court of appeals,[72] the outcome did not need to rest upon equitable principles since the contractual intent of the parties was clear from both the language of the contract and the extrinsic evidence admitted during litigation.[73] As the Iowa Supreme Court pointed out, it is the intent of the parties at the time of contracting which governs the interpretation and enforcement of the agreement.[74] When the contract was executed, the Oakleys believed they had purchased a 320-acre farm which included a house; they did not believe that they had purchased two separate tracts of

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63. May v. Oakley, 407 N.W.2d at 572.
64. *Id.* (Carter, J., dissenting). Justice Neuman joined this dissent. *Id.*
65. *Id.* (Carter, J., dissenting).
66. *Id.* (Carter, J., dissenting).
67. *Id.* (Carter, J., dissenting).
68. Bloethe Interview, *supra* note 11.
69. May v. Oakley, 407 N.W.2d at 571.
70. Bloethe Interview, *supra* note 11.
71. *Id.* It is regarded as common practice for contracts such as the May-Oakley transaction to provide for a separate abstract and deed to be delivered to the buyer upon full payment for each of the respective tracts. Interview with James Monroe, Associate Professor of Law, Drake Law School, Des Moines, Iowa (September 17, 1987).
72. Oakley v. May, slip op., *supra* note 28, at 10.
73. May v. Oakley, 407 N.W.2d at 572 (citing Miller v. American Wonderlands, Inc., 275 N.W.2d at 402).
74. May v. Oakley, 407 N.W.2d at 571.

land via one contract.[75]

Additionally, if Irene Oakley had been granted title to the residence, such a decision would have had an adverse effect on real estate titles of land sold on contract.[76] The Oakleys had assumed the sellers' Farmers Home Administration mortgage at the time of contracting, and this mortgage secured the entire 320-acre farm.[77] If Irene had been allowed to take clear title to the residence, the court would have released a portion of the mortgaged land from the lien, even though the Farmers Home Administration was not a party in the case, and Irene had never contested her obligation to it.[78]

The case illustrates the importance of a buyer's attorney ensuring that, if a separate portion of the contracted real estate has been paid for in full, the sellers deliver a deed and abstract for that property. In this case, if the contract had contained such a requirement, the controversy would have been avoided.

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75. Brief for Appellees at 29, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).

76. Bloethe Interview, *supra* note 11.

77. App. I, *supra* note 8, at 33.

78. Appellees Application for Further Review at 6, May v. Oakley, 407 N.W.2d 569 (Iowa 1987) (No. 85-1563).