

# THE LEASE-PURCHASE AGREEMENT

Information buyers need to know to protect themselves before entering into a lease-purchase agreement

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DO NOT LET A BUYER'S DESIRE FOR HAVING A NICE HOME FOR THEIR FAMILY



END UP LIKE THIS



Buying a home is part of the American Dream for many people. The purchase of a home is the largest purchase most people will make in their lifetime. For that reason alone, it is very important for prospective buyers to examine all of the possible options available to them. Many prospective homebuyers are eager to fulfill this part of the American Dream and may be tempted to take the first 'good deal' that comes their way. The housing market is full of 'good deals' that can turn out to be traps for the unwary. It is important for prospective homebuyers to examine all options so their new home doesn't turn out to be more - or less - than they originally bargained for.

## WHY DO LEASE-PURCHASE AGREEMENTS EXIST?

Without an adequate and reasonably secure income stream, excellent credit, and a large down payment, it is hard to qualify for a home loan from a conventional lender. Qualifying for a loan is even harder, sometimes impossible, without a social security number. While there are some legitimate alternatives for homebuyers who cannot qualify for a conventional loan, these same options can sometimes lead to a less than desirable result. For some, unfortunately, these non-conventional financing tools may be the only options available. Some dishonest sellers may pretend to sell houses when, in reality, they are renting them. The sellers may set up the sale in such a way that it is easy for the buyer to lose both the house and the down payment made on the house.

Sellers typically use one of three methods to accomplish their goal: (1) a **lease with an option to purchase**, (2) a **land installment contract** or (3) a **wrap-around mortgage**. In order to understand how these alternatives differ from a conventional mortgage, it is important to understand what a mortgage generally is and what some of the terms associated with a mortgage mean.

## WHAT IS A MORTGAGE?

A **mortgage** is a loan to finance the purchase of a home. The entity that gives the money to purchase the home is a **lender**. To repay the debt, the borrower (that is, the person buying the house and

borrowing the money) makes monthly payments. When a borrower obtains a mortgage on a house, the buyer will sign a “**deed of trust**” to the lender. This means that the house will be used as security for the loan. The borrower owns the house, but the lender has special rights that protect its ability to be repaid.

#### WHAT MAKES UP A MORTGAGE AND WHAT ARE THE ASSOCIATED COSTS?

All mortgages feature both **principal** and **interest**. Principal and interest comprise the bulk of the borrower’s monthly payments, which reduces the debt over a fixed period of time. **Taxes** and **insurance** costs are other costs that are usually added into monthly mortgage payments.

**Principal** -- The principal is the amount of money borrowed to buy a home. The borrower usually gives the seller a down payment and then borrows the principal to make up the difference between the down payment and the total purchase price.

**Interest** -- Interest is what the lender charges the borrower for the use of the money borrowed to purchase the house. The lender may also charge an additional sum known as “points.” A point is one percent of the amount borrowed.

**Taxes** -- Property taxes are taxes that a community levies annually, based on a percentage of the value of the home and land. The tax is generally used to help finance the cost of running the community by helping to build schools, roads, and other needs. Lenders often collect money from borrowers to pay these, so they can be certain the property does not become burdened with back taxes.

**Homeowners Insurance** -- Lenders will not lend money to borrowers who lack insurance on their homes. The insurance protects both the borrower and lender from losses to the home and personal property by fire, theft, bad weather and other causes.

#### WHAT IS EQUITY?

Homebuyers who finance a purchase of a house with a conventional

mortgage gradually build up an interest called “**equity**” in their homes. Equity is what a house is worth minus any unpaid mortgages or other liens. It represents the part of the house that the buyer owns “free and clear” at any point in time, and it gradually increases over the life of a loan. Equity can also be used to obtain additional loans called equity loans. The equity in the home increases as a buyer pays down the principal balance on the mortgage, as improvements are made to the home, and as property values rise in the community. For example, where a buyer borrowed \$45,000 to purchase a house and has paid enough in payments to reduce the principle amount borrowed by \$15,000, if the house is worth \$70,000, the buyer has built \$40,000 of equity in the home ( $\$70,000 - (\$45,000 - \$15,000) = \$40,000$ ).

#### WHAT IS A FORECLOSURE?

If a buyer does not pay the payments on a mortgage, the lender has the right to take back the house and sell it, because the house was used as security for the loan. The lender will use the money from the sale to pay back the loan. If the sale does not bring enough money to cover the loan, the buyer may be responsible to make up the difference. On the other hand, if any money from the sale is left over after the loan is paid back, the buyer will get what is left over. The amount left over from the sale after paying off the debt represents the buyer’s equity in the house. For example, if a house sold for \$45,000 and the buyer still owed \$25,000 to the lender, the buyer would receive \$20,000 from the sale: the sale price minus the remaining debt of \$25,000.

#### WHAT IS A DUE-ON-SALE CLAUSE?

Most mortgages contain a clause that limits a homeowner’s ability to keep the mortgage on the house if the buyer sells the house to someone else or enters into a contract to lease the house for a long period of time. This clause may give the lender the right to demand the entire amount of the loan at once if the homeowner sells the house or enters into a long-term lease. (Most lenders want to be able to insist on getting paid in full if the house changes hands or goes to a long-term lease, so they insert this clause.)

## THE LEASE-PURCHASE AGREEMENT AS AN ALTERNATIVE TO A CONVENTIONAL MORTGAGE ARRANGEMENT

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### WHAT IS A LEASE-PURCHASE AGREEMENT?

The **lease with an option to purchase**, or **lease-purchase agreement**, is probably the most common home purchase alternative to a mortgage. If a buyer wants to buy a house but cannot qualify for a conventional loan, the seller may offer an alternative where the buyer will pay a down payment and **lease** (or, rent) the house for a given time until an alternate source of financing is found to purchase the house. The “option to purchase” is the right the buyer has under the agreement to purchase the home at or before the given time. The seller may expect to be the one to provide the mortgage in the future, or the seller may require the buyer to secure a mortgage through a bank. If a buyer still cannot qualify for a mortgage loan when the time comes for the buyer to exercise the option to purchase the house, the seller can evict the buyer, keeping the house, the down payment, and the lease payments made up to that time. The buyer is left with nothing.

### HOW ARE LEASE-PURCHASE AGREEMENTS DIFFERENT FROM A TRADITIONAL MORTGAGE?

1. The buyer loses all payments made to the seller if: (1) the seller cancels the lease due to the buyer’s failure to pay a monthly payment or maintain insurance on the property or (2) the buyer fails to exercise the option to purchase when the time comes.

2. Often when a buyer enters into a lease-purchase agreement with a seller, there is already an existing mortgage on the property. If so, the mortgage, through the due-on-sale clause, may actually prohibit the owner from entering into a lease-purchase agreement. If the owner knowingly or unknowingly ignores this clause and enters into a lease-purchase agreement, the owner’s lender may very well have the right to demand the entire amount of the loan. Unless the

buyer or seller has the ability to immediately pay off the underlying loan, all of the buyer’s interests will end through the operation of the due-on-sale clause.

3. There are no protections from the acts of the seller that jeopardize ownership. For example, judgments filed against the seller, bankruptcy of the seller, or the death of the seller may result in all of the buyer’s rights being cut off with no legal recourse against the seller.

4. An unscrupulous seller may transfer the property to another buyer after entering into the lease-purchase agreement, or may borrow money against the house, creating an additional mortgage. The new buyer or lender in that case may cut off all of the original buyer’s rights.

5. The seller in a lease-purchase situation usually requires the buyer to pay for insurance and taxes on the property. If the seller carries a standard homeowner’s insurance policy, the policy is likely to provide that any lease-purchase agreement will terminate the coverage of the policy unless the insurance company agrees otherwise. However, in a case where the seller has a pre-existing mortgage on the property, if the policy is changed to permit a lease, the insurance company will send a new copy of the insurance policy to the lender, thereby alerting the lender to the fact of the lease-purchase agreement and quite possibly triggering the due-on-sale clause. However, if the policy is not changed, the buyer and seller run the risk that there is not a valid insurance policy covering the property. If so, the mortgage will be violated, since there is not a valid insurance policy on the property. Even if the property is insured properly, if something were to happen, the seller will collect the insurance proceeds, but the amount the buyer pays the seller for the house will not be reduced to account for this.

6. Until the buyer pays for the property in full, any improvements to the property (such as new flooring or kitchen cabinets) by the buyer will be the seller’s property. The seller does not have to reimburse

the buyer for costs associated with improvements even if the seller later evicts the buyer.

7. The buyer cannot get an equity loan until the option to purchase is exercised, even though he may be making long-term payments that would build up significant equity under a traditional mortgage.

8. While it is not a difference between a lease-purchase agreement and a conventional mortgage, there is another important characteristic of the lease-purchase agreement that all buyers need to be aware of. Even though a buyer is only leasing the property up until the time the last payment is made, buyers under these deals are not entitled to many of the consumer protections that are otherwise available to “normal” renters.

#### OTHER MORTGAGE ALTERNATIVES

A **land installment contract** is essentially a rent-to-own agreement for a house. While buyers may think they own the house subject to the loan as they would with a mortgage, the contract will say something to the effect that the seller will not transfer the title until the last payment is made, which may be 20 or 30 years later. If the buyer misses even one payment, the transaction functions as a lease agreement, allowing the seller to evict the buyer for non-payment of rent. Barring particular circumstances, the seller can keep the house, the down payment, and all the value of the equity the buyer would have accumulated under a regular mortgage.

**Wrap-around financing** is another alternative to a conventional mortgage. Here, a seller offers a new mortgage which includes the previous mortgage. The buyer makes monthly payments to the seller, and the seller makes payments on the original mortgage and keeps any money that is left over. The buyer is vulnerable, because the original mortgage can be foreclosed by the original lender if the seller does not make the payments on it.

#### WHAT DOES THIS MEAN FOR A POTENTIAL HOMEBUYER?

It may be that homebuyers, such as persons with poor credit or some members of the immigrant community who are unable to access the conventional mortgage market, will decide to enter into agreements that are less than optimal even after considering the alternatives. Their desire to own a home may be so strong that they decide to bear a significant risk. Ultimately, this is a decision each homebuyer must make for himself or herself. This is a decision that, ideally, needs to be made with the aid of competent legal advice. People in the position to provide legal advice or services to potential homebuyers should at least be aware of the possible pitfalls and should look for opportunities to enter into arrangements that are more like mortgages whenever possible. Some sellers may be willing to offer owner financing through a mortgages rather than through a lease-purchase agreement when they understand more about the other alternatives available. In some communities, local economic development and advocacy organizations have succeeded in establishing credit unions that provide home loans structured as mortgages to populations otherwise excluded. Some banks have also begun to seek ways to better serve immigrant homebuyers. However, improving access to home ownership is likely to be a long and complex process. In the meantime, we hope this information has been helpful.

#### CONTACT INFORMATION:

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