

## THE ANDRICH LAW FIRM P.C.

Real Estate · Estate Planning · Commercial Transactions

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### **BEWARE OF THE LEASE PURCHASE CONTRACTS**

During the current economic crisis, the firm is amused by the catch-phrases that attempt to entice buyers and investors: “sub-prime mortgage”, “short-sale”..... It seems that each month, the firm could simply write a newsletter about the catch-phrase of the month. (Is it too early to warn you about the monorail salesman?)

This month’s cool, hip phrase is: “lease-purchase contract”<sup>1</sup>. Undoubtedly, you will hear talk of a lease-purchase (aka: lease-to-own or rent-to-own a house) at parties, around the water-cooler or among your real estate investor colleagues. If someone approaches you with a lease-purchase possibility, **RUN AWAY!!!** That advice remains consistent whether you are a tenant, landlord, realtor or real estate investor.

#### What is a lease-purchase contract?

A written agreement between the tenant and landlord whereby the tenant rents the property for approximately three (3) to five years (5) and then **must purchase the property from the landlord.**

#### What are the drawbacks to a tenant in a lease-purchase contract?

Unlike a standard lease (with an apartment or even single family residence), a lease-purchase contract requires the tenant to maintain the property. Specifically, the tenant must make all the repairs, pay the property taxes, etc. Even worse, the purchase price is agreed by the landlord and tenant at the time the lease is signed. Predictably, the landlord sets the purchase price that is above the projected future fair market value. Furthermore, none of the lease payments should apply to the purchase price.

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<sup>1</sup> The lease-purchase contract **is not the same thing** as a lease-option contract. It is important that before you use any written agreement, please consult with a real estate attorney. Your receipt of **proper legal advice is essential before you participate in any real estate transaction or real estate investment opportunity.** Regardless what the written agreement is called, you must have your attorney review all written agreements before you enter into one.

In plain English: 1) tenant that can barely afford rent and utilities must spend money to make any repairs; 2) if the tenant purchases the property, they shall do so at a price that is often thirty percent (30%) higher than what they would spend on the house next door; 3) If the tenant does not buy the property, they will be thrown out of the house and can be sued by the landlord for failure to buy the house. But the biggest drawback to a tenant is this: **If the landlord has a mortgage on the property and fails to fulfill the mortgage terms, then upon foreclosure, the tenant will be thrown out of the house.** Technically, if the tenant maintains the property, it is a “non-monetary material breach” of most promissory notes and deeds of trust. That means even if the landlord pays the mortgage timely, if the tenant maintains the property, the lender could still foreclosure against the landlord and evict the tenant immediately.

#### What are the drawbacks to a landlord in a lease-purchase contract?

Landlords that deal in lease-purchase contracts must understand one thing: **In all likelihood your tenants will never buy your property.** Why? Many tenants seeking rent-to-own opportunities have been financially destroyed by short-sales, foreclosures or bankruptcies. Unless you can legitimately offer carry-back financing (where you no longer have a mortgage on the property and you will serve as their lender), your tenants will not secure alternative financing. Keep in mind that that tenant’s credit is shot for a minimum of seven (7) years. Therefore, even if the tenant can gather a suitable down payment, no lender will approve their loan application.

Some landlords recognize this first drawback and accept that they will simply rent the property. However, it is nothing short of foolish and stupid for landlords to enter into a three (3) year lease. Why? Landlords will always screw up the rental amounts. If the landlord’s rental rates for years two (2) and three (3) are too high, then the tenant will simply abandon the property and rent somewhere else. (And spare me the argument that you will recover the monies for the remaining two (2) years. Under the Arizona Landlord Tenant Act, there is a landlord duty to mitigate damages – i.e. promptly lease the property to a new tenant)

Landlords will also find themselves in Court. If somehow those lease payments are applied to the purchase of the property, then tenants can sue the landlord for a refund of those payments – regardless of what is stated in the lease. As a “pro-tenant” state (legal catch-phrase), Courts here have no problems in awarding tenants the excess monies paid as monthly rent that were to be applied to the purchase price.

It gets worse for landlords. Because the standard lease-purchase contract requires the tenant to maintain the property and pay for it, the landlord gives up control over what contractors and materials are used. Do you think that a tenant will spend the money (if at all) to hire reputable contractors and instruct them to use suitable wood, pipes, wiring, etc. Not only do you risk depreciating your property's value, but you also potentially void the terms of your insurance policies and mortgage. And for what? Because you decided to sign a standard lease-purchase contract. A stupid landlord is a broke landlord.

### So who wins when using a lease-purchase contract?

If neither the tenant, nor the landlord benefits from a lease-purchase contract, then whom?

#### 1) Do the Realtors?

Maybe – a good realtor will seize the opportunity to earn commissions when the lease is executed; when the purchase contract is signed; and when closing commences. Smart realtors will execute a listing agreement that offers a low teaser commission (unusually one percent (1%) when the property sells), but earn a higher commission upon producing a tenant that enters into the lease purchase (not surprisingly, six percent (6%)).

Nevertheless, realtors often lack the necessary disclosure forms to protect themselves from civil litigation or Arizona Department of Real Estate (“ADRE”) complaints. Foolishly, they neglect to prepare the proper documents; attempt to draft the documents on their own; or even worse; rely on some pre-historic documents created by their designated broker or Arizona Association of Realtors. The realtor never recognizes their mistake until standing in the presence of the Administrative Actions Division of the ADRE. A realtor that does not retain a lawyer to prepare their disclosures is a stupid realtor that will soon have a terminated license. Oh – and you will have to return those commissions when the tenant and/or landlord sues you.

#### 2) The Big Winner – The Companies Claiming to Assist Real Estate Investors

You have to admire a company's ability to seize an opportunity. Someone sat at a restaurant a few months ago and decided: “Hey, the real estate market is dead. The last time this happened was in the 1980's. Lease-purchase contracts were hip and profitable back then. How can I financially take advantage, given this knowledge?”

Look in any real estate publication and you will find these companies. They target real estate investors with a little money or property for lease/sale. "Come to our seminar," they say. "Join our investment group. We will show you how to do it." Lawyers marvel at how quickly investors run to these events. This firm's clients send us to these seminars; review them; and then properly advise the clients. The big idea offered by investment groups right now: LEASE-PURCHASE CONTRACT.

How do investment companies profit from their efforts? They take your money without taking any of the risks to the investment (i.e. defaults on mortgages, lawsuits by tenants and buyers against the landlord/seller and ultimately failing to accomplished what the company promised investors). Miraculously, the investor companies pay realtors commissions for bringing real estate investors to the investor group. Amusingly, while company representatives announcing that they are not making an offering for the sale of securities – they are. Either with your property, or your money, you are buying shares in an investment company. Realtors – pay attention: As soon as you earn one of those commissions, if you do not have a license to sell securities, you are probably in violation of numerous SEC and Arizona securities violations.

**THERE ARE MANY WAYS TO BE A SUCCESSFUL REAL ESTATE INVESTOR IN THIS CURRENT MARKET. THE LEASE-PURCHASE CONTRACT IS NOT ONE OF THEM!!!**