

LEASES WITH OPTIONS

I. INTRODUCTION

Sellers who are unable to sell their home may elect to offer to lease it with an option to purchase. The sellers may hope that this arrangement will give them a stream of income during the term of lease that is sufficient to cover their mortgage payment as well as the property taxes and insurance expenses. There are, however, a number of issues that should be considered prior to entering into a lease/option arrangement.

II. DISCUSSION

A. Crafting a Proper Option to Purchase

An option to purchase gives the holder the right to elect to purchase a property at a particular price. In other words, an option is an irrevocable offer to sell a property for a particular period of time. If the option is exercised, it must be executed prior to its stated expiration date. Unlike time deadlines in other contracts, traditionally Michigan courts have strictly enforced time deadlines in option contracts. This is true for the other terms of an option contract as well. So, for example, if an option provides that you must exercise the option by hand delivering written notice to the seller, do not attempt to exercise your option via email.

An option should be effective upon its exercise. It should not require parties to execute a separate purchase agreement. Because of this, an option contract should spell out the essential terms of the purchase – *e.g.*, title insurance requirements, commission obligations, inspection requirements, tax proration methods, etc. Without these provisions, the option may be difficult to enforce. If, for example, I have an option to buy your home for \$200,000, but we have not agreed upon the other essential terms of purchase, then rather than attempt to draft these additional terms on our behalf, a court may simply find the agreement to be unenforceable. A sample form of option clause for a lease agreement is attached as Exhibit A.

It is typical, but not necessary, for some portion of the rental payments received during the term of the lease to be applied toward the purchase price in the event the option is exercised. Option fees are typically forfeited in the event the option is not exercised. Again, however, this is a matter subject to negotiation.

In order to encourage a tenant to make timely rental payments during the term of the lease, a seller may wish to consider including a clause that provides that the tenant's purchase rights will automatically terminate in the event of a default (or a series of defaults) under the lease.

B. Memorandums/Recording

To protect their rights in a home as against subsequent purchasers, persons holding an option to purchase will want to have an interest of record with the appropriate register of deeds. While the option itself may be recorded, oftentimes parties prefer to record a memorandum which simply acknowledges the existence of the option, but does not make the terms of such contract a matter of public record. A sample memorandum of option is attached as Exhibit B. A party may wish to omit notary blocks from the option agreement itself in order to prevent the other party from later recording the instrument.

C. Due-on-Sale Issues

Most, if not all, residential mortgages contain a due-on-sale clause which requires that a mortgage be paid off if there is a change in ownership. Federal law specifically provides that due-on-sale clauses are enforceable by federally regulated lenders. Other lenders are governed by the somewhat more complicated Michigan statute. As a general rule, REALTORS® should assume that a mortgage contains a due-on-sale clause and that it is enforceable.

A typical due-on-sale clause provides something like this:

If all or any part of the property is transferred without the lender's prior written consent, the lender may require all sums secured thereby immediately due and payable.

Whether a due-on-sale clause is triggered by a lease/option may depend on the specific language of the due-on-sale clause and/or the terms of the lease/option itself. Many mortgages expressly provide that specific types of leases and/or leases/options will trigger the due-on-sale clause. Others provide generally that the clause applies in the event of a transfer of *any interest* in the property.

Commentators often point out that there are no federal or state statutes that make it a crime to violate a due-on-sale clause. It is simply a contractual obligation pursuant to which if the lender discovers the transfer, it may choose to call the loan. While this is certainly true, REALTORS® should never advise a client as to whether a particular due-on-sale clause covers lease options or whether it is likely that the lender will discover the transfer and call the loan. While it is not against the law to violate a due-on-sale clause, it is against the law for a person who is licensed to do business in this state to knowingly assist a person in evading the enforcement of a due-on-sale clause. MCL 445.1628(2). A real estate licensee can be fined up to \$5,000 for each offense and be subject to revocation of his license for a violation of this law. Sellers should be advised that it is almost certain that their mortgage contains such a clause and that they should discuss this matter with an attorney before proceeding forward with a lease/option agreement.

D. Principal Residence Exemption and Other Property Tax Issues

A home that is leased does not qualify for the principal residence exemption (previously known as a “homestead exemption”). As a result, a homeowner who leases his home may experience a significant property tax increase.

Moreover, a lease option will be a transfer subject to the “pop up” tax if the lease is for more than 35 years (including all renewal options) or if the option price is not more than 80% of the property’s projected value at the end of the lease.

If the tenant defaults and the lease is terminated, the homeowner will not be able to resurrect his homestead exemption. Once the home is leased, the homestead exemption is forever lost unless a homeowner moves back into his home and reestablishes it as his principal residence. Returning to the home will not, however, help a homeowner whose taxable value has been adjusted as a result of a lease/option. A homeowner who moves back into his house after suffering through a bad tenant may, with time, be able to reestablish his homestead exemption, but will not be able to reestablish the taxable value as the value that was in place prior to the lease/option.

E. Local Rental Ordinance Issues/Restrictions

Persons who wish to rent their homes should check with their local government to determine whether there are any required permits, licenses, inspections or fees. There may also be applicable subdivision or condominium restrictions of record that prohibit or restrict rentals. And there may be unique issues depending upon the location of the property. For example, the City of East Lansing has an ordinance pursuant to which rentals are prohibited in certain areas within the City. Over the years, the City of East Lansing has also settled many code violation matters by imposing a “consensual” deed restriction which prohibits any future rentals of that particular home. The only way to know about leasing restrictions is to contact the municipality and also to obtain a title search.

F. Insurance Issues

Many insurance policies require continued owner occupancy. While obviously there are policies available for leased homes, the premium is typically higher. Homeowners should discuss this issue with their insurance agent before they lease the home. A seller who does not address this issue who suffers a fire or other casualty may end up with a denied claim. While the cost of insurance may be passed onto a tenant, the homeowner will want to make sure that he is protected by obtaining the coverage himself and collecting reimbursement from this tenant.

G. Financial Risks to Owners and Tenants

A tenant with an option to purchase will want to make certain that the homeowner does not owe more on his house than the option price. Similarly, if the homeowner/landowner is responsible for paying taxes and insurance, the tenant will want to make certain that these items are current. These concerns are particularly important where the tenant will have a significant investment in the property by the time the option is exercised.

The homeowner, on the other hand, will want to take steps to protect his investment should the tenant be unwilling or unable to exercise the option to purchase. A homeowner typically will want control over the extent and nature of any renovations made to the home before the home is actually sold. Likewise, the homeowner will want control over sublets and assignments of the lease/option rights.

III. CONCLUSION

The purpose of this article is not to encourage REALTORS[®] to begin drafting lease option agreements or to offer legal advice as to advisability of such a course of action. Rather, the purpose of this article is to familiarize REALTORS[®] with various issues that may arise with lease/options. Clients should always be strongly encouraged to seek the assistance of counsel when considering lease/options.

EXHIBIT A

SAMPLE OPTION CLAUSE FOR INSERTION IN LEASE

Landlord hereby grants Tenant the option to purchase the Property (the "Option to Purchase") for a total purchase price of _____ (\$_____) (the "Purchase Price") by providing notice of the exercise of the Option to Purchase during the term of this Lease (the "Option Period"). The terms of the Option to Purchase shall be as follows:

- a. Within fourteen (14) days of the Commencement Date, Tenant shall obtain a commitment for an owner's policy of title insurance with standard exceptions for the amount of the Purchase Price. Upon receipt of the commitment, Tenant shall notify Landlord of any objections to the condition of the title, including any conditions reflected in the commitment which render title unmarketable, within fourteen (14) days of receipt, and thereafter, Landlord shall have thirty (30) days to cure any such defects. If Tenant's objections to the condition of the title are not timely cured, Tenant may either: (i) terminate the Lease and receive a refund of the Earnest Money; or (ii) waive his objections. In the event the Option to Purchase is exercised, Landlord shall provide, at its expense a policy of title insurance in the amount of the Purchase Price pursuant to the commitment approved by Tenant pursuant to this Section. If Tenant exercises its Option to Purchase, any objection to condition of title, including any conditions reflected in the commitment which may render title unmarketable, shall be deemed waived by Tenant.
- b. Tenant may exercise the Option by delivering to Landlord written notice of its intent to exercise the Option to Purchase during the term hereof.
- c. Upon exercise of the Option to Purchase, Landlord and Tenant shall close the transaction within _____ days thereafter.
- d. Upon closing of the sale of the Property, Landlord shall convey fee simple title to Tenant by a warranty deed in recordable form.
- e. Upon closing of the sale of the Property, Landlord shall pay all county and state transfer taxes associated with the conveyance. Tenant shall pay the cost of recording the warranty deed. Landlord and Tenant will share equally the title company's closing costs.
- f. One hundred (100%) percent of the divisions available under Section 108 of the Land Division Act are to be transferred by Landlord to Tenant upon closing after Tenant's exercise of the Option to Purchase. Landlord makes no representations as to the number of divisions available.
- g. Tenant shall have no right to exercise its Option to Purchase if it is in default under the terms of this Lease during the period of time permitted for exercise of the Option to Purchase until it cures any such default during the period for exercise of its Option to Purchase.
- h. Tenant shall not have the right to assign its interest in the Option to Purchase without the Landlord's prior written consent.
- i. Landlord agrees that at the request of Tenant, it shall execute a Memorandum of Option Agreement which shall evidence Tenant's Option to Purchase, which shall be in recordable form and may be recorded by Tenant with the Register of Deeds for the County of _____.

EXHIBIT B

MEMORANDUM OF OPTION AGREEMENT

THIS MEMORANDUM OF OPTION is made and entered into as of the _____ day of _____ 200__, between _____, a Michigan _____, whose address is _____ (“Optionor”), and _____, a Michigan _____, the address of which is _____ (“Optionee”).

WITNESSETH:

For valuable consideration, Optionor has granted to Optionee an option, commencing on the date hereof (the “Commencement Date”) and expiring on _____ (the “Expiration Date”), to purchase a certain parcel of land situated in the Township of _____, _____ County, Michigan, more specifically described in Exhibit 1 attached hereto (the “Property”), pursuant to the terms of a certain option agreement dated this date between the parties hereto (the “Option Agreement”).

This instrument is executed for the purpose of giving public record of the fact of the execution of the Option Agreement and all the terms and conditions of the Option Agreement are incorporated herein by reference, and any reference to the Option Agreement may be made by referring to the Liber and Page in which this Memorandum of Option Agreement is recorded in the office of the Register of Deeds of _____ County, Michigan.

IN WITNESS WHEREOF, the parties hereto have executed this Memorandum of Option Agreement as of the day and year first above written.

OPTIONOR:

By: _____
Its: _____

STATE OF MICHIGAN)
)ss
COUNTY OF _____)

The foregoing instrument was acknowledged before me, a Notary Public, this _____ day of _____ 200__, by _____, the _____ of _____

EXHIBIT 1

Legal Description for Property