

Rent-to-own an option in tough real estate market

Robert Hollis, Special to The Chronicle

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In these times, when some plummeting markets have vaporized half of the value of their single largest asset, putting together a traditional deal to sell has become an ordeal sometimes bordering on the impossible.

Homeowners who find themselves in distress, for whatever reason, can't find buyers. Likewise, many would-be buyers are frustrated because the nation's unprecedented credit squeeze has made mortgage money vanish like a rabbit down a hole.

For some, it's time to get creative: Enter the lease-option deal, otherwise known as rent-to-own. These arrangements - around for decades - are contracts between buyers and sellers that don't involve banks, mortgage companies or, necessarily, real estate agents.

As the name implies, a lease-option or rent-to-own transaction involves a potential buyer locking in an option to acquire a home at a later date at a fixed price. The buyer usually makes a nonrefundable deposit and moves in immediately as a renter. Part of each month's rent may go toward a down payment, depending on the contract.

Rent-to-own deals typically range from a year to four years, with most running for 24 months, according to Michael Hironimus, director of sales for National Realty in Pleasanton. Prior to joining National Realty, Hironimus ran a lease-option business on the Peninsula and said he did more than two dozen such deals in 2007 in Northern California.

At the end of the rental period, the buyer must come up with a balloon payment for the balance owed on the dwelling, or walk away from the deal. Ideally, the buyer has had time to save for a down payment and arrange financing.

Nontraditional route

Based on interviews and listings in places such as Craigslist, evidence suggests that these sometimes risky transactions are on the increase, especially in those hard-hit Bay Area housing markets such as parts of Oakland and Richmond. They are also increasingly prevalent statewide wherever home prices are dropping, according to those involved in lease-option transactions.

"I did it because I couldn't sell my house" in Rocklin (Placer County) using conventional methods, said Leo Stewart, 48, a Pacific Gas and Electric Co. employee who now lives in Auburn. Putting his 15-year-old 3-bedroom, 2-bath home on the market in 2006, he found himself cutting his asking price as the market

began to tank. After several months with no offers, he decided to try a lease-option sale using a Sacramento firm called OptionPlus Homes that specializes in such deals.

Another compelling reason to change tactics was that he didn't want to pay the sales commission and fees associated with a traditional sale through a licensed agent, he said.

So far, Stewart's sale remains unconsummated, but he remains convinced that he's on the right track. After one would-be buyer moved out without completing the purchase, OptionPlus found a second candidate who is currently renting the home for about \$1,700 a month under a contract that calls for him to buy the place for \$450,000 next year, Stewart said.

I don't expect him to buy," Stewart said, because the home has continued to lose value and may be only worth \$350,000 now. He is unsure what the prospective buyer will do once the rental period has run its course next year. Nevertheless, he says he's happy with the arrangement under which OptionPlus screens his tenants, collects the rent (keeping a portion) and handles all the paperwork.

The lease-option business is expanding said Craig Sherman, founder of OptionPlus of Sacramento. His business puts together deals between buyers and sellers in Northern California and Portland, Ore. He says he expects to open offices in Southern California and Chicago soon.

Dickey deals

Despite their appeal in hard times, rent-to-buy transactions offer benefits and risks to both buyers and sellers. They are clearly not the answer for everyone, say many real estate agents.

For buyers with bruised credit or not enough cash for a traditional 20 percent down payment, a rent-to-own agreement can benefit them by allowing time to build equity until conditions improve and/or until they repair their credit ratings to qualify for a traditional mortgage.

But the risks can be numerous. In the current housing malaise, the purchase price buyers agree upon today could turn out to be too high a year or two down the road if home values continue to collapse, as is the case mentioned above.

And there's no guarantee that the would-be buyer can find a willing lender in the future, especially if he or she can't qualify for a mortgage now.

On the plus side for sellers, lease-option deals can put some cash in their pockets in a market where properties languish for months or years. Also, because owners may sell without real estate commissions, they may be able to keep more of the purchase price - if the sale goes through.

But a bad tenant who welshes on the rent or trashes the property and then walks away can spoil everything. Or if the tenant-from-hell refuses to go, eviction can be expensive and drawn out.

Hironimus, who said he found his lease-option business to be profitable, acknowledged that there are many possible ways to get into trouble. "It really comes down to how solid the contract is" between the

buyer and seller, he said.

A good contract is one that anticipates every possible pitfall that can occur, contains terms covering the smallest details and allows for renegotiation (such as price adjustments) should market changes threaten the deal, he said.

At a minimum, he recommends that each side have the draft lease-option contract reviewed by a lawyer well-versed in real estate law before either party signs the document. Indeed, a better approach would be to have the contract drawn up by an expert in real estate law.

Investors' vehicle

Geraldine Barry, founder and president of the San Jose Real Estate Investors Association, is about to take the plunge into the lease-option world and she's feeling optimistic about it.

She and her husband, Stuart Baeriswyl, made what in hindsight was a smart move when they sold off their Stockton real estate holdings in 2005 on the advice of other investors in her organization, which she founded in 2002. "They warned us of the impending storm," she recalled.

Armed with the cash proceeds, the couple this fall closed on two investment properties in Antioch for which they paid \$137,000 and \$144,000. These were homes that would have sold for about \$400,000 before the market crash, she said.

After some whirlwind rehabilitation, the couple was able to rent one dwelling for \$1,575 a month. They recently offered the other one for sale under a lease-option financing arrangement.

Barry said she and her husband decided to go the nontraditional route, despite the risks, because of the lack of available buyers who can obtain mortgages and the lengthy period that homes in east Contra Costa County have been sitting on the market unsold.

From her perspective, the lease-option approach offers a steady source of rental income for two years or so in a period of great housing market and economic uncertainty. If the buyer is coming off of a foreclosure, the rental period "gives you a couple of years to clean up your credit rating," she said.

At the same time, "I would know in a couple of years if (the potential buyer) is going to be a good credit risk or if I'm going to have to drag each month's rent out of him."

Set up for success

Caroline Hegarty of Vallejo has done 15 lease-option deals but agrees that buyers need to be very careful because of the significant amount of fraud associated with rent-to-buy schemes.

"I've heard stories where (purported owners) don't even own the property" they're trying to sell, she said. Before signing anything, would-be buyers need to thoroughly investigate the status of the home in question and the individual trying to sell it.

At the same time, Hegarty said she has a "very strict screening policy" to vet would-be buyers because she has heard of cases of sellers being burned by deadbeats or those bent on fraud.

"The whole process (of buying homes and setting up deals) is very time consuming" and is not something that can be done as a hobby, she said. Indeed, the two cases in which deals fell through because of walk-aways, she said she mistakenly "outsourced" the selection of her tenant-buyers. Now she does all background work herself.

Hegarty advises homeowners looking to set up a rent-to-own deal to read up on the matter. She said she found books by self-styled real estate guru Andy Heller to be helpful.

Her secret, she said, is to treat her renter-buyers with respect once she's carefully selected them and offer them generous terms, typically allocating about 25 percent of the rent toward the purchase price.

To make the deal work and sell the house, "you have to set them up for success."

Buyer beware

-- If the seller's home is repossessed, or something else goes wrong, a rent-to-own buyer may lose any money paid, including his or her often significant deposit.

-- The lease-option contract should spell out the smallest details, such as who is responsible for home repairs, who pays for maintenance and what happens if the buyer misses a rent payment or the seller misses a mortgage payment.

-- Always run the proposed contract past a lawyer well-versed in real estate law. Even better, have her or him draw it up.

-- Always do a background check on the seller. Does he or she actually own the property in question? Ask for and pay for a credit check. If the seller balks, consider it a big red flag.

-- Renters should treat the transaction like they're buying a house. Get an appraisal, a pest and home inspection.

-- If you're not ready financially to buy a home, don't sign a contract. Better to wait and build your savings.

Seller beware

-- Thoroughly vet prospective renter-buyers, including a credit check, employment status and salary history.

-- Insist on a strong, detailed contract (see above). Be prepared to modify the terms if the market changes.

-- Resist the temptation to price the home unrealistically. Get an appraisal if necessary. Asking too much - even if your tenant-buyer agrees - could result in a walk-away or worse because the tenant cannot finance

the deal.

-- Keep the mind-set of helping the renter become a homeowner; encourage him or her to behave like one, taking good care of the property.

-- Eviction can be a nightmare if the renter defaults.

-- The seller is still responsible for property taxes and should always carry insurance (your lender will require it, even if you're selling via a lease option).

-- Even the best sounding deals are risky. Be vigilant and set up regular inspections of the home in the contract during the rental period.

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