



## White Paper

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### *Leasing and Seller Financing*

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2012





# Leasing and Seller Financing

## **PART ONE: INTRODUCTION**

As a result of current market conditions, REALTORS® are increasingly faced with two obstacles: sellers who are unable to sell their property and buyers who are unable to qualify for a loan because of a recent bankruptcy, foreclosure, or other credit problems. A potential solution for both of these problems may be leasing the property or seller financing. Lease purchase agreements, lease options, purchase money mortgages and land installment contracts are all types of arrangements that potential parties to a real estate transaction may consider.

Because many REALTORS® have little, if any, experience with these types of transactions, it is important for them to familiarize themselves with the legal issues involved so they can properly represent the best interests of their clients. The purpose of this White Paper is to provide a brief overview of some of these legal considerations.

## **PART TWO: LEASING PROPERTY**

### **Evaluating Whether to Lease**

Before leasing a property, the advantages and disadvantages of doing so should be discussed with the owner. The main advantage for an owner to lease property is to provide a revenue stream to offset the costs associated with owning the property. However, leasing property involves certain risks, including the possibility that the tenant will damage the property, thereby making the future sale or rental of the property more difficult and costly. The tenant may also breach the terms of the lease, most commonly by failing to pay the rent. Failure by the tenant to vacate the property voluntarily will result in the owner having to initiate eviction proceedings. Most owners will be unfamiliar with this process which can take up to two months and will likely require the use of legal counsel.

Owners who consider leasing their property will also need to make sure that they are familiar with their responsibilities under a variety of state and federal laws including Ohio's Landlord Tenant Act, the Fair Credit Reporting Act, the Fair Housing laws, and the lead-based paint requirements.

Finally, a property owner should also determine whether leasing their property will violate the terms of their mortgage and result in any tax consequences because the property is no longer being used as their primary residence. While REALTORS® need to raise these issues with their client, they should refrain from providing tax or legal advice. Instead, the owner should be referred to their own legal counsel or tax professional for such advice.

## Licensing Requirements

Under Ohio law, leasing property for an owner for any type of valuable consideration requires a real estate license. As such, real estate salespersons are required to perform this activity in the name of the brokerage with which they are licensed.

## Exclusive Right to Lease Agreement

Before a REALTOR® begins to market a property for lease, it is important that an agreement be entered into with the property owner that outlines the REALTOR®'s duties and the compensation to be paid the brokerage. If the property is already listed for sale and the owner now decides to lease the property, the listing agreement should be reviewed to determine if leasing, and the compensation that will be paid for that service, is covered in the listing. In most cases an exclusive right to sell agreement will not address this. In this case, either an addendum to the listing should be entered into or a separate exclusive right to lease should be signed.

Because a listing to lease property is a contract to perform acts that require a license, it is considered an agency agreement. As such, the license law requires that it contain certain provisions. These mandatory provisions are:

- (1) A definite expiration date;
- (2) If the agreement is for residential property, the required fair housing language and logo;
- (3) A place for the licensee and the owner to sign and date the agreement.

Moreover the license law requires that a copy of the signed agreement must be provided to the owner.

In addition, the listing agreement should also address the following:

- (1) The terms on which the owner will lease the property including:
  - a. Monthly rental rate
  - b. The security deposit, specifying by whom it will be held
  - c. Lease term (i.e., one year, 18 months)
  - d. Other key terms such as the number of occupants, pets, payment of utilities, etc.
- (2) Define the scope of the leasing agent's duties including:
  - a. Providing documents such as rental applications and leases
  - b. Screening tenants
  - c. Approval of tenants
  - d. Ongoing management services during the term of the lease
- (3) An agreement that the landlord will comply with all applicable laws including the fair housing laws, lead-based paint disclosures, and the Fair Credit Reporting Act

- (4) Compensation to be paid, including whether any fee is due upon lease renewal, purchase of the property by the tenant or for property management services.

## **Agency Disclosures**

Unless the REALTOR® has already provided the owner with a Consumer Guide to Agency Relationships in the course of listing the owner's property for sale, the REALTOR® is required to provide the owner with this disclosure before the property is shown to potential tenants or marketed.

With respect to potential tenants, Ohio's agency law provides that a Consumer Guide and Agency Disclosure Statement is only required to be given to a potential tenant if the property is commercial, industrial, retail, or involves a residential lease over 18 months. Thus, if the property is residential and the lease is 18 months or less, a REALTOR® is not required to give the prospective tenant a Consumer Guide or Agency Disclosure Statement.

## **Securing a Tenant**

Once the exclusive right to lease has been entered into and the rental rate has been set, the REALTOR® can begin to market the property. Prospective tenants should complete a rental application and go through the tenant screening process. The REALTOR® and owner should determine who will screen prospective tenants. This usually includes obtaining a consumer report from a credit bureau or a tenant screening service. If a consumer report is used, compliance with the Fair Credit Reporting Act is required. This includes providing an adverse action notice if an application is denied based upon information contained in the consumer report or credit score.

## **Lease Agreement**

It will also be necessary for the REALTOR® to discuss with the owner the lease agreement that will be used. Although the owner may want the REALTOR® to supply the lease, unless the brokerage regularly engages in property management, it will probably not have a lease form. Because a lease can be structured in a variety of ways, it is recommended that the owner be referred to their own attorney to provide the lease agreement. *(A worksheet identifying some of the basic terms the attorney will need to draft this agreement is attached at the end of this White Paper labeled "Residential Lease Worksheet.")*

## **Trust Account Requirements**

Under Ohio law any funds received by a REALTOR® in a fiduciary capacity must be deposited in the brokerage trust account. This would include security deposits and rental payments. The trust account into which the funds are to be deposited and held depends upon whether the REALTOR® is going to manage the property after the lease is executed.

If the REALTOR® will be managing the rental property on behalf of the owner following execution of the lease and the security deposit and rents collected are going to be held by the brokerage, they must be deposited in a separate property management account in the brokerage name. More information on property management trust account requirements and handling security deposits is included in OAR's [White Paper on Property Management](#).

On the other hand, if the REALTOR® has no further duties following execution of the lease and is only collecting, but not retaining, a security deposit and first and/or last month(s) rent, a separate property management trust account is not required. Instead, such monies must either be:

- (1) Collected in the name of the owner, or
- (2) Collected in the name of the brokerage, deposited in the brokerage's regular trust account and then disbursed to the owner.

### **Managing the Property**

As stated above, some owners may want to utilize the services of their REALTOR® to manage the property after their property has been leased. Such management usually includes collecting rent, handling maintenance requests, and paying the mortgage, property taxes, utilities and other expenses on behalf of the owner. Because property management is an activity that requires a license, it must be done through the brokerage. Therefore, agents who are interested in providing this service must first discuss this with his/her broker.

A brokerage considering offering property management services should realize that this area of practice requires knowledge of the specific property management requirements under the real estate license law, as well as knowledge of other laws. Brokerages that are interested in providing property management services should also contact their errors and omissions insurance provider to make sure this type of service is covered. More in depth information on this topic can be found in the [OAR Property Management White Paper](#).

### **PART THREE: LEASE WITH OPTION TO PURCHASE**

In certain circumstances, a potential buyer who does not currently qualify for financing to purchase property may want to enter into a lease with the option to purchase, hoping that mortgage financing may be available to them in the future. Under a lease option agreement, the tenant is not obligated to purchase the property, but merely has the option of doing so on agreed upon terms for the length of the option.

#### **Advantages and Disadvantages**

The advantage of this type of arrangement for the tenant is obvious: the tenant is able to occupy a home without the obligation to purchase it, but reserves the right to do so if their circumstances later permit. For owners, such a lease option can have advantages as well. All or part of the costs

of owning the property can be covered by a tenant who, because of the possibility of owning the property in the future, is motivated to maintain it.

However, this type of agreement also presents risks for both parties. The owner, by granting the tenant the option to purchase, may lose the opportunity to sell the property for a higher price to another purchaser. Moreover, as with any lease, the owner has obligations under the Ohio Landlord Tenant Act and faces the risk that the tenant may damage the property and/or breach the terms of the lease. For this reason, the lease option agreement should clearly address whether such a breach will terminate the tenant's option to purchase.

As stated in Section Two, the owner should also determine whether such a lease option violates the terms of their mortgage or could have unintended tax consequences.

For the tenant, the ability to exercise the option may be jeopardized by the owner's financial soundness. An owner in financial trouble may file bankruptcy or the owner's lender may initiate a foreclosure action, nullifying the tenant's ability to purchase the property. It is also possible that tax and other liens could be placed on the property during the lease that will impede the future sale of the property to the tenant.

### **The Lease Option Agreement**

This type of arrangement involves an agreement between the parties as to the terms of three separate transactions: a lease, an option and a purchase contract if the option is exercised. The terms of these three transactions can be included in one fairly lengthy document or separate documents could be executed (i.e., a lease and a separate option to purchase).

Like a purchase agreement, an option must be supported by consideration, generally referred to as an option fee. Under the terms of an option agreement, such a fee is generally non-refundable, but could be applied to the purchase price if the option is exercised. The option agreement should also spell out the length of the option, the manner in which it is to be exercised, and whether it is assignable.

To assure that there is a clear understanding of the terms on which the tenant will purchase the property if the option is exercised, it is crucial that the agreement be specific and not just address the sales price. Rather it should spell out the typical terms included in a purchase contract (earnest money, financing, inspections, closing date, etc.). The option agreement should also address whether all or a portion of the rental payments and/or security deposit will be credited toward the purchase price if the option is exercised.

Because there are different ways to structure a lease with an option to purchase agreement, it is recommended that the parties be referred to an attorney to draft this agreement and to provide legal advice. *(A worksheet identifying some of the basic terms the attorney will need to draft this agreement is attached at the end of this White Paper labeled "Option to Purchase Contract Worksheet.")*

## Brokerage Compensation

Finally, licensees representing the parties to a lease option agreement should also make sure that there is a clear written agreement regarding payment of the commission. This agreement should clarify the commission that is due upon execution of the lease and upon purchase of the property if the tenant chooses to exercise the option.

## PART FOUR: LEASE PURCHASE AGREEMENT

A lease purchase agreement is similar to a lease with the option to purchase, but with an important distinction: instead of merely having the *option* to purchase, under a lease purchase agreement, the tenant is *required* to purchase the property at the end of the lease.

### Advantages and Disadvantages

The main advantage for the owner under this type of transaction is that unlike a lease option where the tenant has no obligation to purchase the property, under a lease purchase agreement the tenant is contractually bound to purchase the property at the end of the lease on terms that are agreed upon upfront.

This type of agreement holds the same certain inherent risks for the owner that exist with a lease option. However, because this transaction involves a lease, the owner must comply with the statutory duties imposed by the Landlord Tenant Act, including the duty to maintain the property and make repairs. Moreover, the owner bears the risk that the tenant will damage the property, breach the terms of the lease or fail to purchase the property at the end of the lease. Further, the owner is also contractually bound to sell the property on the agreed upon terms at the end of the lease regardless of whether the owner's circumstances change, the property value increases or another offer to purchase is obtained.

As discussed earlier, it is also important to determine whether such an agreement may violate the terms of the any mortgage there may be on the property. To assess these and other risks, the owner should be referred to his own attorney for advice. The owner should also be referred to a tax professional for advice on the tax consequences of entering into such an agreement.

The advantages and disadvantages for the tenant with this type of agreement are also similar to those under a lease option. However, because this is a binding agreement, the tenant can be subject to a breach of contract action if the tenant fails to perform. Another risk for the tenant is that, depending on market conditions, the value of the property could decrease, resulting in the tenant paying more for the property than it is worth at the end of the lease.

As with any contract, the tenant also runs the risk that the owner will be unable to perform at the end of the lease term. For this reason, at the time the contract is executed the tenant may want to confirm that the owner has the ability to convey the title by having a title exam performed. Of course this will not protect the tenant from subsequent liens being placed on the property, a foreclosure action being filed by the owner's lender, or the owner filing for bankruptcy.

## **The Lease Purchase Agreement**

In addition to advising the owner and tenant on the issues discussed above, legal counsel will be needed to draft the lease purchase agreement. The lease purchase agreement should address several key terms including the terms of the lease, the terms of sale, earnest money deposits, whether rental payments and other deposits will be credited to the purchase price, payment of taxes and insurance, remedies, etc. The agreement should also address whether failure to pay rent will terminate the tenant's right to purchase the property. *(A worksheet identifying some of the basic terms the attorney will need to draft this agreement is attached at the end of this White Paper labeled "Lease/Purchase Contract Worksheet.")*

## **Brokerage Commission**

Finally, the REALTOR(S)<sup>®</sup> involved in the transaction need to assure that there is a written document protecting their right to a commission. Specifically, this agreement should specify the fee to be paid upon execution of the lease and/or closing of the sale of the property.

## **PART FIVE: PURCHASE MONEY MORTGAGE**

In those instances where a buyer is unable to obtain lender financing, a seller may agree to act as a bank financing the transaction. This type of financing is referred to as a purchase money mortgage.

Under such an agreement, the seller conveys title to the purchaser and the purchaser signs a note that is secured by a mortgage held by the seller. Such seller financing is only an available option if the seller owns the property free and clear of any mortgage or other encumbrances.

Clearly an attorney must draft the necessary documents in this type of transaction. Moreover, the seller should obtain legal counsel to advise him as to the obvious risks associated with this type of financing, namely that the buyer will default on their loan. In that event, the seller will be forced to file a foreclosure action, which can be lengthy and will most likely require hiring legal counsel.

## **PART SIX: LAND INSTALLMENT CONTRACTS**

A land installment contract provides another vehicle for a buyer who may not currently qualify for lender financing to purchase property. Popular in the 1980's, such agreements have not been widely used in recent years when financing was more widely available.

Also referred to as a land contract, the sale of residential property by this type of agreement is governed by the Ohio Revised Code Chapter 5313. Unlike a purchase money mortgage where the purchaser takes title to the property, under a land contract, the seller (or vendor) retains title to the property. The buyer (or vendee) usually makes a down payment and pays monthly

installment payments of principal and interest over a number of years, with a balloon payment due at the end of that term.

### **Advantages and Disadvantages**

Like a lease purchase agreement discussed above, a land contract allows a person who is not currently able to purchase property by traditional means the ability to take possession of a property, and to cement their right to finance the transaction at a later date. More importantly, though, Ohio law contains statutory provisions to safeguard the interests of the vendee under a land installment contract that are intended to protect their interests in the property. These provisions are discussed below.

As to the vendor, the major benefit is not only having a contract that obligates the vendee to purchase the property at a later date, but the vendor also receives a down payment from the vendee, as well as interest on the monthly payments. However, by entering into such a land contract, the vendor may violate the terms of a mortgage he has on the property and possibly trigger a due on sale clause. Thus, it is important to refer the vendor to legal counsel to review his mortgage documents.

The other main disadvantage of a land contract for the vendor is that in the event of a default by the vendee, the vendor must file a legal action to terminate the vendee's rights and gain restitution of the property. Discussed in more detail below, such legal action will require the vendor to hire an attorney and is costly in terms of time and money. Moreover, the vendor also risks that a vendee who defaults may not have maintained the property, leaving the vendor with a property in a deteriorated condition. For these reasons, the vendor should carefully consider the vendee's financial ability to perform the terms of the land contract.

### **Statutory Regulation of Land Installment Contracts**

The Ohio Revised Code requires that a land contract for the sale of residential property contain certain mandatory provisions. These provisions are:

- (1) The full names and the current mailing addresses of all the parties to the contract;
- (2) The date when the contract was signed by each party;
- (3) A legal description of the property conveyed;
- (4) The contract price of the property conveyed;
- (5) Any charges or fees for services that are includable in the contract separate from the contract price;
- (6) The amount of the vendee's down payment;
- (7) The principal balance owed, which is the sum of the items specified in divisions (4) and (5) of this section less the item specified in division (6) of this section;
- (8) The amount and due date of each installment payment;
- (9) The interest rate on the unpaid balance and the method of computing the rate;
- (10) A statement of any encumbrances against the property conveyed;

- (11) A statement requiring the vendor to deliver a general warranty deed on completion of the contract, or another deed that is available when the vendor is legally unable to deliver a general warranty deed;
- (12) A provision that the vendor provide evidence of title in accordance with the prevailing custom in the area in which the property is located;
- (13) A provision that, if the vendor defaults on any mortgage on the property, the vendee can pay on that mortgage and receive credit on the land installment contract;
- (14) A provision that the vendor shall cause a copy of the contract to be recorded;
- (15) A requirement that the vendee be responsible for the payment of taxes, assessments, and other charges against the property from the date of the contract, unless agreed to the contrary;
- (16) A statement of any pending order of any public agency against the property.

In addition to the mandatory terms, other provisions may be included in the land contract for the protection of the parties. Thus, while the licensee can assist the parties in negotiating key terms of a sale by land contract (i.e., price, interest rate, length, down payment amount), the parties must be referred to an attorney to draft the land contract and provide legal advice. *(A worksheet identifying some of the basic terms the attorney will need to draft this agreement is attached at the end of this White Paper labeled "Land Installment Contract Worksheet.")*

### **Other Statutory Provisions**

In addition to mandating certain contract terms, the Ohio Revised Code also provides other limitations and duties. Some of these are:

- A duty to record the land contract within 20 days after it has been signed by the buyer and seller; a copy must also be provided to the county auditor;
- A prohibition against the vendor having a mortgage on the property that is greater than the balance owed under the contract without the consent of the vendee;
- A requirement that the vendor provide a statement to the vendee showing the principal, interest and unpaid balance at least annually, or on demand of the vendee, but no more than twice a year.

### **Default by Vendee**

If the vendee defaults on payments due under the land contract, the action that the vendor must initiate to terminate the vendee's rights is referred to as forfeiture. Under this process, the court can declare that the vendee's rights are forfeited and grant any other claims resulting from the contract, including restitution of the property by the owner. Before the vendor initiates this process, however, the vendee must be notified that they have a 30 day grace period to bring payments current and pay any fees provided for in the contract.

However, if the vendee under the land contract has made payments for five years or more or has paid 20% or more of the purchase price, the seller must initiate a foreclosure process and the

property must be sold by judicial sale. This is the same process that must be followed by lenders holding a mortgage or a seller holding a purchase money mortgage.

### **Brokerage Commission**

As stated previously, there should be a clear written agreement between the REALTOR(S)<sup>®</sup> and owner regarding payment of a commission. This agreement should specify if the full commission is due upon execution of the land contract by the parties or completion of the contract when title is actually conveyed.

### **CONCLUSION**

Today's market continues to pose new challenges for buyers, sellers and the real estate industry. As the market stabilizes, it may be necessary for REALTORS<sup>®</sup> and their clients to consider other options. While leasing and seller financing may pose opportunities to achieve a client's needs, all aspects of such transactions must be fully considered. Because a REALTOR<sup>®</sup>'s fiduciary duty is to protect the best interests of his or her client, it is important for REALTORS<sup>®</sup> to have a good understanding of such transactions before advising clients and to recognize the need to involve legal counsel early in the process.

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*The information presented in this White Paper is not intended to be--and should not be construed as--legal advice. Any REALTOR<sup>®</sup> who is contemplating assisting clients in leasing property, or in entering into any of the other types of transactions discussed in this White Paper should first consult with his or her own broker, legal counsel, and E&O insurance carrier.*



## Residential Lease Worksheet

*(Basic information to be agreed upon by parties and provided to legal counsel drafting a residential lease.)*

*Because a Residential Lease is a legally binding contract between the parties, it must be drafted by an attorney. The purpose of this form is to only identify some of the basic information necessary for legal counsel to draft this document.*



### A. Basic Information:

Landlord(s)	Tenant(s)
Name(s)	Name(s)
Address	Address
Property Address <i>(legal description if available)</i>	
Occupants  _____	

### B. Lease Terms:

Term	Commencement Date
Monthly Rent \$	Security Deposit \$
Late Fee \$	Right to Assign/Sublet Yes _____ No _____
Pets No _____ Yes _____ Pet Fee \$ _____	

### C. Utilities/Maintenance: *(check responsible party)*

	Landlord	Tenant
Electric		
Gas		
Water		
Sewage & Storm Water		
Trash		
Cable/Internet		
Lawn/Snow Removal		

### D. Brokerage Commissions:

Listing Brokerage	Tenant's Brokerage
Fee	Fee
Paid by	Paid By
Payment Due Date	Payment Due Date



## Option to Purchase Contract Worksheet

*(Basic information to be agreed upon by parties and provided to legal counsel drafting a land installment contract.)*



*Because an Option to Purchase is a legally binding contract between the parties, it must be drafted by an attorney. The purpose of this form is to only identify some of the basic information necessary for legal counsel to draft this document.*

### A. Basic Information:

Seller/Optionor(s)	Purchaser/Optionee(s)
Name(s)	Name(s)
Address	Address
Property Address <i>(legal description if available)</i>	

### B. Option to Purchase Terms:

Term of Option	Commencement Date
Option Fee \$ _____ Refundable _____ Non-refundable _____	Assignable Yes _____ No _____
Notice Required to Exercise	
Right to Terminate Option for Failure to Pay Rent Yes _____ No _____ Violation of Other Lease Terms Yes _____ No _____	

### C. Purchase Terms if Option Exercised:

Purchase Price \$ _____	Earnest Money \$ _____
Require Proof of Financing Yes _____ No _____	Credits Toward Purchase Price Rent Yes _____ No _____ Security Deposit Yes _____ No _____ Option Fee Yes _____ No _____ Other _____
Right to Inspect Yes _____ No _____ Inspection Period _____ days Commencement Date _____	Payment of Closing Costs
Closing Date _____ days from date of notice of exercise of option _____ other	

### D. Brokerage Commissions:

Listing Brokerage	Tenant/Buyer Brokerage
Fee	Fee
Paid by	Paid By
Payment Due Date	Payment Due Date



## Lease/Purchase Contract Worksheet

*(Basic information to be agreed upon by parties and provided to legal counsel drafting a residential lease.)*

*Because a Lease Purchase Contract is a legally binding contract between the parties, it must be drafted by an attorney. The purpose of this form is to only identify some of the basic information necessary for legal counsel to draft this document.*



### A. Basic Information:

Landlord(s)	Tenant(s)
Name(s)	Name(s)
Address	Address
<b>Property Address</b> <i>(legal description if available)</i>	
<b>Occupants</b>	
_____	_____
_____	_____
_____	_____

### B. Lease Terms:

Term	Commencement Date
Monthly Rent \$	Security Deposit \$
Late Fee \$	Right to Assign/Sublet Yes _____ No _____
Pets No _____ Yes _____ Pet Fee \$ _____	

### C. Utilities/Maintenance: *(check responsible party during lease term)*

	Landlord	Tenant
Electric		
Gas		
Water		
Sewage & Storm Water		
Trash		
Cable/Internet		
Lawn/Snow Removal		

**D. Purchase Terms:**

Purchase Price \$	Earnest Money \$
Financing Terms	Credits Toward Purchase Price Rent Yes ____ No ____ Security Deposit Yes ____ No ____ Other _____
Right to Inspect Yes ____ No ____ Inspection Period _____ days Commencement Date _____	Payment of Closing Costs
Closing Date	

**E. Brokerage Commissions:**

Listing Brokerage	Buyer Brokerage
Fee	Fee
Paid by	Paid By
Payment Due Date	Payment Due Date



## Land Installment Contract Worksheet

*(Basic information to be agreed upon by parties and provided to legal counsel drafting a land installment contract.)*

*Because a Land Installment Contract is a legally binding contract between the parties, it must be drafted by an attorney. The purpose of this form is to only identify some of the basic information necessary for legal counsel to draft this document.*



### A. Basic Information:

Seller(s)	Purchaser(s)
Name(s)	Name(s)
Address	Address
Property Address <i>(legal description if available)</i>	

### B. Purchase Terms:

Purchase Price \$	Interest Rate
Down Payment \$	Amortization Period
Monthly Payment \$	Commencement Date
Late Fee \$	Term of Contract

### C. Responsible Party for Property Expenses: *(check responsible party or indicate how expenses will be shared)*

	Seller	Purchaser
<b>Property Taxes</b>		
<b>Utilities</b>		
<b>Insurance</b>		
Casualty		
Liability		
<b>Repairs &amp; Maintenance</b>		
Interior		
Exterior		
Structural		

### D. Brokerage Commissions:

Listing Brokerage	Buyer Brokerage
Fee	Fee
Paid by	Paid By
Payment Due Date	Payment Due Date



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