

Lease/Options & the Equitable Interest

by Bill Bronchick

I get a lot of emails and calls from people concerned about selling a property by lease with option because of the fear of the "equitable interest". What does this mean and how big of a danger is it? Before we discuss the equitable interest, we need to discuss the basic owner-financed sale. When you sell a property, you give the buyer a deed to transfer ownership. If you owned the property free and clear before you sold it, you would take back a note for part of the purchase price, secured by a lien on the property (in some states a "mortgage", in others a "deed of trust"). So, after the closing the buyer would have title (deed) and you would have a recorded lien against the property ("mortgage" or "deed of trust"). If the buyer stopped paying, you'd have to initiate foreclosure proceedings as specified by the mortgage or deed of trust. In mortgage states, the process is generally a lawsuit (judicial foreclosure), while deed of trust states the process is a "power of sale" (non-judicial) process.

Before we move on to the lease/option, let's discuss the installment land contract. The installment land contract is an agreement by which the buyer makes payments under an agreement of sale in installment payments. The transaction is also known by the expressions, "contract for deed," and "agreement for deed." The seller holds title as security until the balance is paid. In many respects, the land contract is identical to a mortgage, in that the buyer takes possession of the property, maintains it and pays taxes and insurance. However, title remains in the seller's name until the balance of the debt is paid. In many states, the installment land contract is considered the equivalent of a mortgage, in that the seller must commence foreclosure proceedings to remove the defaulting buyer.

If you sell the property by lease with option to purchase, it's not really a "sale" at all. The lease creates a landlord-tenant relationship. The option gives the buyer the right to purchase the property during the lease term at a specified price. If the tenant/buyer defaults, you evict him like any other tenant. However, once you go into court, the tenant/buyer may raise the "equitable interest" argument. In essence, the tenant/buyer is arguing that the lease/option agreement is essentially the equivalent of a sale, similar to an installment land contract. The tenant is asking the judge to rule that the buyer "owns" the property (even though title has not passed) and that the landlord is the equivalent of a lender. If true, the landlord must now proceed with a judicial foreclosure process instead of an eviction, which takes several extra months.

Logistically, the proceedings follow a certain path through the courts. In most parts of the country, the local civil courts have three levels - small claims, limited jurisdiction, general jurisdiction. The small claims court are like the "People's Court" shows on T.V. - nobody can bring a lawyer and the maximum you can sue for is limited to about \$5,000, give or take. The general jurisdiction courts can hear any kind of claim from a divorce to a foreclosure to a slip and fall case for \$10,000,000. The limited jurisdiction court is in between the two; you can use a lawyer and bring certain types of claims, including an eviction proceeding. The different courts have different names, depending on which state you live in. In my state (Colorado), the limited jurisdiction court is called "County Court" and the general jurisdiction court is called "District Court". In New York, where I used to practice law, there were called "City" courts (limited jurisdiction) and "Supreme Courts" (general jurisdiction).

The limited jurisdiction court cannot hear foreclosure cases or property ownership disputes. Since the eviction proceeding is brought in the limited jurisdiction court, there is the risk that the tenant may raise the "equitable interest" argument. If this happens, the judge cannot decide the dispute because he lacks jurisdiction. The judge will have to transfer the case to the general jurisdiction court for a hearing. This may cause a delay of a few weeks to a few months. Since time is money, this is not good for the landlord, which is why some lawyers will start the eviction in the general jurisdiction court if they believe the tenant plans to fight the eviction (this may cost more in attorney fees than bringing an eviction in the lower courts, but will be faster if there needs to be a hearing on the equitable interest).

Either way, in most cases the general jurisdiction court will reject the tenant/buyer's argument and permit the landlord's eviction. Why? Well, the tenant/buyer is asking the court to use its "equitable" powers to rule that a lease/option is not a lease/option, but a sale. The court is being asked to turn a document into something it isn't in the matter of "fairness" (equity). Obviously, it's a judgment call for a judge, but in my experience this rarely happens. Here are some of the factors the judge will consider:

- How long has the tenant been in the property?
- How substantial was the default?
- How were the documents drafted (i.e., does the lease/option look more like a contract for deed?)
- Has the tenant done improvements, and are those improvements valuable?
- How much money did the buyer put down?
- What's the difference between the tenant's option price and the current market value of the property?

The last two factors are extremely relevant, since they will determine how big of a piece of the pie the parties are fighting for. If the option price was \$200,000, the tenant put up \$5,000 and defaulted a year later and the market value is now \$210,000, it is doubtful a judge would rule in the tenant's favor. It's not "equitable". On the other hand, if the tenant put up \$20,000, lived in the property three years and the market value was now \$250,000, the judge might rule in favor of the tenant's equitable argument. In this case, there's \$70,000 of equity worth fighting over, so it's not that big a deal if you have to pay a lawyer \$5,000 to foreclose. In short, don't believe the urban myth that all lease/options end up requiring a foreclosure. Most of the time the "fairness" doctrine works just fine - the tenant/buyers without equity end up being evicted and the tenant/buyers with substantial equity get to keep it (or get foreclosed). And, of course, you should have a well-drafted lease/option agreement with your tenant/buyer.

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