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LEASE-OPTIONS OF TEXAS RESIDENTIAL PROPERTY

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Lease-Options have always been a favorite tool of residential real estate investors. It is easy to get tenant/buyers in and usually easy to get them out through the forcible detainer (eviction) process. However, changes to the Texas Property Code Sec. 5.062 *et seq.* made in 2005 define lease-options for longer than 6 months as “executory contracts” which are subject to strict regulation under the Code. But what exactly is an executory contract and why should sellers and investors be concerned about it?

Executory contracts include any transaction that defers some action by either party that pertains to ownership or possession of real property into the future. Think of it this way: an “executed” contract is one that is fully performed today. It is done, finished. An “executory” contract, on the other hand, leaves something dangling. Usually the dangling item is the most important item of all, namely, who owns the property and when do they get the deed?

An option to purchase, in a technical sense, is a unilateral contract which gives the holder of the option *the right to compel sale of the property at certain price.* It must, *inter alia*, be in writing, exercisable within a specific term, and either recite a price or a formula to compute a price. It is distinguished from an option in that a ROFR merely requires the owner, when and if he or she decides to sell, to first offer the property to the holder (ie., the buyer). ROFR’s generally do not specify a price. Depending on how the ROFR is worded, the seller may be required to first negotiate a specific deal with a third-party buyer and then freeze that transaction momentarily while the holder of the ROFR is given a chance, for a specified time, to buy the property at the same price and terms. Often the price is to be determined by what fair market value is at the time of sale. As soon as you include a specific price, it is likely that an ROFR will be interpreted as an option. ROFR’s are therefore not an effective substitute for an investor seller who wants to pre-set an above-market price in order to lock in a long-term profit.

There are two lesser forms of preferential or pre-emptive right:

- (1) a right of first offer (ROFO) which obligates the seller to notify a buyer of his intention to sell, and the buyer will then have the right to make an offer, the terms of which are not specified in advance; and
- (2) a right of first negotiation (ROFN), which obligates the seller to negotiate

exclusively with the buyer for a prescribed period of time. Price and terms of sale are open.

In a typical executory contract one party (the seller) holds “legal title” to the property. This usually means he retains a deed to the property in his name. The other party (the buyer) holds “equitable title,” meaning that he has only an equitable right to receive legal title at some time in the future if certain conditions are met. This arrangement gives an advantage to the seller, because enforcement of “equitable rights” by a purchaser generally involves filing suit and asking that one’s equitable rights be recognized by a court and enforced - a lengthy and expensive process at best. Buyers under financial pressure are more likely to abandon their option rights along with their down payments.

In the past, unscrupulous sellers used this situation to their advantage. They disregarded the buyer’s equitable rights, representing to Justices of the Peace that such buyers were ordinary tenants subject to ordinary leases, obtaining evictions for minor or technical defaults, and often confiscating large down payments in the process. The seller was then free to move on to his next “victim” and obtain another down payment. The legislature rightly acted to stop such abuse.

Look carefully at Section 2(a)2 of the Property Code: “An option to purchase real property that includes or is combined or executed concurrently with a residential lease agreement, together with the lease, is considered an executory contract for conveyance of real property.” There is an exception for lease-options for six months or less - otherwise, the residential sales contract promulgated by the Texas Real Estate Commission would have violated this provision if combined with a temporary lease. Note that options not combined with a lease as well as options on commercial property are *not* affected.

So why not simply use lease-options anyway and accept falling within the definition of an executory contract? Many requirements now exist that did not apply before the 2005 revisions to the Property Code. The option must be recorded; an annual accounting statement must be given; there is a right of conversion; lender approval is required; and there are specific notice and disclosure requirements that must be observed, including 30 days notice and right to cure in event of default (60 days if more than 40% of the purchase price has already been paid). Executory contracts are no longer advisable or even feasible in Texas unless the property is paid for or used exclusively for commercial purposes. In addition to stiff penalties, certain violations of the executory contracts provisions of the Code are defined to be DTPA violations, which can result in treble damages plus attorney’s fees.

In an effort to continue to use lease-options, and avoid requirements imposed by the Property Code on executory contracts, many investors have resorted to calling them something else – “deferred purchase” plans, “rent to own,” and the like. This does not work. One can call a cat a dog but that does not change the nature of the beast. Courts look to substance over form. Moreover, a judge and jury will likely be angry with a seller who tries to pull a fast one with overly-clever verbage - and more inclined to consider a finding of fraud.

Recognize that courts and juries generally do not favor investors. Investors are often perceived as profiteers preying upon the weak and helpless. It often does not matter how clever

your legal argument is. If a transaction does not pass the “smell test” a seller will likely lose. Underestimate a jury of 6 or 12 of your peers at your peril. Even if the executory contract rules are found not to apply, remember that the court can look to the “laundry list” of offenses under the Deceptive Trade Practices-Consumer Protection Act. Section 17.50(a)(3) of the Act prohibits “any unconscionable action or course of action by any person” – an exceptionally broad statement.

Forfeiture remains a hot-button area. Section 5.073(a)(4) of the amended Property Code prohibits a forfeiture of a buyer’s down payment or option fee if a monthly payment is late. This is an important change, because it codifies what judges and juries have been telling lawyers for quite some time. They *hate* forfeitures. The trend in the law is to view *any* substantial forfeiture as unreasonable and unconscionable, whether within the context of an executory contract or not, if it results in a buyer losing either a large down payment or the home itself.

Another caution: “seminar forms” or forms off the internet, never much good since they were not designed specifically for Texas, can now get you in real trouble. If you have such forms entitled Purchase Option Agreement, Option Cancellation and Release Agreement, Option to Purchase Real Estate, Performance Mortgage to Secure Option, Secured Reverse Assignment Agreement, Slick Tricks to Get What I Want Without Telling Anyone What I’m Doing, and the like, they are toxic waste in the State of Texas. Throw them away.

Find a good real estate lawyer, one with courtroom experience, and consult him regularly. His fees are cheap insurance. Pay attention to what he says about how a judge or jury will react to your proposed deal. A good lawyer knows that documents should be drafted as if you will one day have to defend them in court.

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