Lease-Options & Land Contracts are increasingly complex with nuances that can easily lead to expensive mistakes for the ill-informed. This e-Book addresses some of the essential but oft-misunderstood concepts governing land contracts in Indiana. This e-Book is written for landlords, real estate investors and property management companies operating residential rental businesses.
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CHAPTER 1
Important Background on Lease-Options

Why Landlords Need to Know the History of Lease-Options

Over the past several years, there have been many changes in the use and the courts’ treatment of lease-options. Even state and local legislative bodies have begun to regulate lease-options. In Cincinnati, for example, there is now a “predatory leasing” ordinance that regulates lease-option contracts. Georgia, as another example, has regulated lease-options by state law, and more states are critically viewing leases with options as a form of needed consumer protection. And, the rate of changes in the use and regulation of lease-options is accelerating. But why? What’s happening to lease-options?

In short, real estate guru’s taught investors to over-use and abuse lease-options. Back in the late 1990’s, residential landlords rarely used lease-options. It was a different breed of real estate investor who used lease-options. Lease-options were more common in commercial real estate deals and farmland than they were in residential deals. However, more and more national and regional real estate investment speakers began advocating lease-options for residential properties. Books and tapes and CD-ROMs full of lease-option forms proliferated in number, and investors become very aggressive about how to structure lease-options. Largely based on bad advice from these national and regional speakers, real estate investors started taking very large “down payments” from renters. Investors went to “boot camps” and seminars, and were taught that large “down payments,” coupled with regular turnover of tenants, equated to a source of steady income of “option money,” much like monthly rent payments themselves. Eviction rates did not fall. To the contrary, landlords were encouraged to evict tenants after collecting those large option fees. And so, tenants who were not qualified to be buyers paid big bucks and signed “rent-to-own” contracts, on the promise of home ownership in the future. Later, those tenants were evicted, and new tenants took their places, signed new lease-options, and paid more option fees. And, landlords laughed all the way to the bank.

Not everyone and not every landlord are laughing today. Some of those tenants, who eventually lost their “down payments,” filed lawsuits and have found sympathetic judges. Others found their state legislators. And, so the regulation of lease-options began. Slowly over the past many years, it has become more difficult and precarious to offer a tenant a legitimate and fair lease-option. Too often, because lease-options are now being abused and misused on a frequent basis, landlords cannot evict tenants under the lease, merely because there is also an option agreement between the landlord and tenant.
The problem is that the many courts and some state legislatures are now treating lease-options as if they were land contracts. And, in most states, land contracts are treated as notes and mortgages, which require enforcement of the state’s foreclosure statute, rather than the landlord seeking the quicker and less expensive eviction or forfeiture remedies. The question has become: Does this lease-option really constitute a land contract, and thus note and mortgage?

**Land Contracts Contrasted**

Under a land contract, the buyer has possession and control of your property, and it is often expensive to regain that possession and control. Again, to repeat the point, under an old Indiana appellate decision, land contracts are treated as notes and mortgages, which require the prosecution of a foreclosure action and a foreclosure sale. Forfeiture, which is similar to an ejectment or eviction of a tenant, may not be an available remedy against the defaulting land contract buyer. Foreclosures, as opposed to forfeitures, are slow and expensive. And, just before you get your property back at the sheriff’s sale, the buyer might file bankruptcy, which automatically stays the foreclosure sale. In bankruptcy, a forfeited land contract receives far less favorable treatment than do a note and mortgage.

In theory, our courts require foreclosure, rather than permit forfeiture, as a means of protecting a buyer who has substantial equity in the subject real estate. The reality is usually very different. Usually, the buyer does not have substantial equity in the property. He only thinks he does. And, the buyer has stopped paying the seller by the time a lawsuit is filed, which further reduces the buyer’s illusionary “equity cushion.” Add attorneys’ fees, court costs and sheriff’s costs to the equation, and the seller usually will be eligible to seek a deficiency judgment, even after getting the property back after the sheriff’s sale.

Years ago, one solution to the forfeiture-foreclosure problem was to sell property using a lease and an option to purchase. Back in the 1990’s, there was a clear distinction between lease-options and land contracts. A true lease-option is actually two documents representing two separate transactions: (1) a lease with (2) a separate option to purchase. A land contract is one, single transaction.

**Lease-Options Offer a Win-Win Scenario**

In general, lease-options enable a landlord to sell a property at a price on the high end of fair market value to a buyer who presently does not qualify for third-party financing, but who is
likely to qualify for financing at the end of the lease term (usually 12 to 24 months). The landlord can also collect an option fee at the time the lease is signed and additional option fees during the life of the option. The option fees compensate the landlord for keeping the property off the market during the option term and improve cash flow. The tenant gains access to a property worth purchasing, re-establishes his credit, and pre-pays, essentially, a part of the down payment. This gives the tenant a good reason to remain current on the lease and close on the purchase.

Because investors are abusing lease-options, there is a definitely a trend for judges to re-write lease-options by treating them like land contracts, requiring foreclosure and not permitting an eviction. It is hard to imagine having to file and prosecute a foreclosure lawsuit in order to evict a deadbeat tenant, but that has become a reality, as some judges decide to change the law and your lease-option agreements.

One solution to this problem is to elect judges who do not aspire to be legislators and who are willing to honor agreements as written by the parties. That is not a very practical solution. A more practical solution is to avoid giving a judge good reason to re-characterize your lease-option as land contract. How? Here are some suggestions.
CHAPTER 2
Two Transactions, Not One

A “lease-option” is actually two transactions occurring at or near the same time between the same parties. The first is the execution of a standard residential lease. The second is the granting to the tenant of a special option to purchase the property in the future. The landlord does not want to link the lease and option, thereby giving a court a reason to treat the lease-option as one transaction. So, the guidelines and suggestions that follow largely address the mistake of linking, in any way, the lease to the option. The more the lease and the option are linked, the greater the chance that a court will view the documents as evidencing one transaction, namely a land contract.

The Basics

The landlord should require an initial option fee for the option, which is in addition to any security deposit or first month’s rent. The monthly rent should be equal to the fair market rent; however, the landlord should charge an additional option fee, payable in one lump sum or monthly. The option fee, if paid monthly, should be paid by separate check than the rent check.

The total of the additional option fees should be about the same as the discount given from

EXAMPLE

If the property is worth $100,000 today and would be worth as much as $105,000 after one year, the deal could be structured as follows:

- Lease for one year with rent equal to $900 per month (the market rent); and
- Option to be exercised during a 12-month period for a purchase price of $100,000 at closing; an initial option fee of $1,000 and additional option fees of $333.33 ($4,000.00 divided by 12 months) per month.
- Alternatively, option to be exercised during a 12-month period for a purchase price of $103,000 at closing; an initial option fee of $2,000.

the future fair market value of the property at closing, or some other amount calculated to compensate the landlord for removing the property from the market during the option period. This will leave the landlord in financially the same position as if the property were sold at the end of the lease to a third party at fair market value, but provides an incentive to the tenant not to default under the lease and to keep the property in good repair.
In the past, the landlord might give the tenant a rent credit equal to a portion of the monthly option fees. I now longer advocate that approach. **Why?** Because it creates another link between the lease and the option. In any case, if the tenant does not purchase the property then all option fees are forfeited.

**Use Separate Documents**

A common mistake is to merge the lease, the option, and the purchase agreement into the same “short” form. This can be extremely dangerous for the landlord, because it allows the tenant (or worse, a court) to interpret the lease as a land contract or purchase agreement, and thus delay or prevent eviction by demanding foreclosure. These problems often arise in the tenant’s bankruptcy.

The option should either include the terms of the purchase or incorporate by reference a separate attached purchase agreement. My preference for landlords is that the option agreement be short and that a purchase agreement be attached. Do not refer to the option or the purchase itself in the lease. The purchase agreement would not be signed, however, until the option is exercised by the tenant. The purchase agreement should be fully negotiated with all its provisions completed. Only the lease and option agreement should be fully executed (signed) at the initial document closing. The attached purchase agreement is not signed, because the tenant has not exercised the option and has not agreed to purchase the property. Later, when the option is exercised, the purchase agreement is signed and serves to replace the option agreement.

If the landlord is also going to be financing the tenant’s purchase of the property, then attach unsigned forms of the warranty deed, note and mortgage to the purchase agreement. You should also consider using lead-based paint forms and disclosures when the lease is signed. However, the state-required Seller’s Residential Real Estate Sales Disclosure forms should not be completed or signed at the time the lease and option are signed. **Why?** Because that is evidence that the entire transaction is really a sale disguised as a lease-option. When the option is exercised and the purchase agreement is actually signed, then the real estate disclosure form can be signed and dated the same date as is the purchase agreement.

**Other Timing Considerations**

I used to advocate signing the lease and the option agreement at the same time. This area of the law is changing, and so too must sound business practices change to track the changes in
the law. Now, I prefer to sign and date the option agreement months after the lease is signed. I now tell tenants that I will negotiate with them the terms of an option agreement, under certain conditions: 1) the tenant must pay all rent on time, 2) the tenant must show efforts to remove any bad credit marks on the tenant’s credit report, 3) the tenant must actively work with a mortgage broker in an effort to obtain financing or pre-approval, and 4) the tenant cannot otherwise breach the lease. Then, if all these conditions are being met over a period of four to six months, subject to my sole approval, then I will negotiate the terms of a fair option agreement. Using this procedure, there are four to six months separating my lease and my option agreement. Additionally, I know that I have a serious potential buyer who really wants to clean up her credit, obtain financing, take good care of my property, and will likely get financing to close on the purchase of my building. I have improved my legal position, in the event I have to evict the tenant, and I have improved the chances that my tenant will close on the purchase.

**Language Is Important**

Use good legal forms. Do not simply use the forms you purchased from a non-lawyer, national speaker, or from the office supply store. Use professionally-written legal forms. In other words, NEVER use a legal form, unless your legal adviser wrote it, fixed it or approved it.

My first lease-option lawsuit for a client was a bankruptcy case, in which the landlord-client had his tenants sign a one-page “Rent to Own” form. The facts were not in my favor, and we settled the case. There was very little that was done well in that “Rent to Own” form. The problems started with the title of the agreement: “Rent to Own.” This was really a lease and purchase agreement and option all rolled into one document. The form used the term “down payment,” rather than “option fee.” The landlord was called the “seller.” The tenant was called the “buyer.” The entire document was littered with language suggesting that the tenant was purchasing the property. And, that language suggested a land contract, rather than a lease
with a separate option agreement. There’s an expression in my profession: “Bad facts make bad law.” In other words, relative to lease-options, if you use bad legal forms, you might get a bad result in court. Don’t be cheap- buy good legal forms from a knowledgeable attorney who understands lease-options.

Since my first lease-option lawsuit, I have handled dozens upon dozens of similar disputes. Unfortunately, the legal forms sold by regional and national speakers are still being used, and those forms still contain bad draftsmanship and poorly chosen language. In the end, poorly drafted legal forms can cause bad results and significant financial losses for the real estate investor. If you do not have lease-option forms, call your real estate attorney and get his forms. If you already have forms, have your real estate attorney review and correct them. And remember that not every attorney fully understands lease-options and the recent developments in this area of the law. Pick the right attorney, or be prepared to educate your attorney about lease-options. However you do it, make sure that your legal forms are in good order and contain the appropriate language.

**Multiple Checks**

The landlord should collect multiple checks, each check representing a different obligation under a different agreement. In other words, the tenant will pay the first month’s rent, a security deposit (sometimes called last month’s rent), an option fee or monthly option fees, and, once the option is exercised, a separate down payment or escrow payment. Each of these payments is made at different times, under the different agreements: the lease, the option agreement, and the purchase agreement, respectively. The memo portion of each check should describe the nature of the payment: “security deposit” or “down payment” or “option fee.”

By collecting different checks at different times, the landlord is making it clear that there are separate agreements, not a single transaction that looks like a land contract.

**The Option Fee Amount**

Many investors are getting bad advice about the amount of option fees to charge a tenant. The option fee is supposed to compensate the landlord for keeping the property off the market during the option term. An option agreement is not a license to cheat and steal from tenants who are hoping to buy a home. Yet, more and more investors are taking ever-bigger
option fees from tenants. These huge option fees more than compensate the landlord for keeping the property off the market during the option term. These big option fees look like down payments to the courts. Frankly, these big option fees look like down payments to me, and I am a pro-landlord attorney.

The reason some judges are treating lease-options as land contracts is because the tenant-buyer is believed to have substantial equity in the property. Judges tend to be fair and try to right wrongs.

These judges perceive that the tenant is being cheated out of substantial equity. So, structure your lease-options in a way that makes it difficult for a judge to find that the tenant will lose meaningful equity in an eviction. There is a simple way to accomplish this task. Increase the purchase price or the rent, dollar for dollar, by the amount that you lower the option fee.

**How big is an option fee that has become too big?** That depends on several factors. What is the property worth today? What will the property be worth at the end of the option period? What is the appreciation rate in the area? How good or bad is the tenant’s credit? What are the other risks to the landlord? How long is the option period? By answering these questions and keeping in mind that option fees are intended to compensate the landlord for keeping the property off the market during the option term, the well-advised investor can determine a fair option fee that does not look like a down payment.

**EXAMPLE**

If you would have normally charged $4,000 as an option fee, consider charging $1,600 as the option fee, increase the rent by $100 per month and raise the purchase price by $1,200. If the tenant does not exercise the option, your profits will be $1,200 less than the $4,000 you had hoped to get. However, by using this technique, you significantly increase your chances of avoiding an expensive foreclosure case, in the event the tenant fights the eviction and the judge decides to re-write your contract.

As a final thought, remember that pre-payment of the last month’s rent or any amount greater than the first month’s rent will be considered a security deposit under Indiana’s 45-Day Letter Rule. Make sure to treat security deposits as security deposits, even if you call them something else.
CHAPTER 3
The Right Tenant. The Right Property.

The Tenant/Buyer Should Be Better Than The Typical Tenant

The tenant/buyer should be more credit-worthy than a typical tenant and should have a strong desire to purchase the property. The landlord/seller should have a desire to sell the property in the near future. The tenant’s income needs to be higher to support the additional option fees and the tenant will pay more cash up front. Also, the tenant should be required to perform more of the regular maintenance and repair duties than a typical tenant. However, do not expect the tenant/buyer to keep his/her promises to maintain the property. You should inspect the property regularly.

Picking the Right Property

Not every property is a good lease-option property. In the example above, the house had a fair market value of $100,000. How about a more expensive house? Can you option a $380,000 house? Yes, but most tenants who can afford to buy a $380,000 home can obtain typical financing. The market for $380,000 lease-options is rather narrow. How about a $40,000 home? That market might even be narrower than the $380,000 house market. Why? Because there are few tenants with good-paying jobs and good credit who would want to live in a $40,000 house, and that segment of the mortgage lending industry has shrunk, making it a challenge to get the tenant-buyer financed. The best market to sell properties using lease-options is somewhere between the $70,000 house and the $350,000 house. You should give serious thought to the appropriateness of selling by lease-option on a property by property basis, and tenant by tenant basis. In short, the deal must make sense and be likely to close.
CHAPTER 4
Important Deal Terms

The Length of the Option Term/Period

You need to give your tenant time to repair her credit and obtain financing. That takes 12 months or longer in most cases. On the other hand, you do not want to keep your property off the market for two years or longer. A longer option period suggests that the tenant is buying the property over time. Again, a lease-option looks more like a land contract, if the option period is very long. I prefer an option period of 12 to 18 months. If you want to renew the option period after 18 months, then negotiate an extension, sign new agreements, and collect another option fee.

No Public Notice of the Option

The holder of an option to purchase real estate does not own an interest in the property itself, but merely holds a contract right to force the seller to convey the property to the holder of the option according to the terms set forth in the option. That is the fundamental difference between a lease-option and a land contract. Thus, the option should never be recorded and, if the tenant/buyer defaults on the lease, the option should not be discussed in the eviction or damages proceedings. The option shall expressly state that it may not be recorded.

Close the Sale as Soon as Possible

A potentially dangerous time for the landlord arises after the tenant has delivered notice of exercising the option and before the closing. This is because the tenant acquires an interest in the property by exercising the option but is supposed to continue paying rent until the closing. Any default under the lease at this time may not be sufficient to terminate the option rights unless the documentation of the transaction is clear. The last thing the landlord wants is to be forced into a superior or circuit court, as opposed to a small claims court, to foreclose or forfeit a tenant who has paid only the option fees, is no longer paying any rent, and is unwilling or unable to close on the purchase. One possible solution to this problem is to include language in the option indicating that the option cannot be exercised or is voided automatically in the event of any default under the lease.
Notice of Default & Termination of Option

When the tenant breaches the lease, the landlord has the right to terminate the option. That is done by the landlord sending notice to the tenant that the landlord has terminated the option. Most landlords fail to do send notice, creating an issue to debate before a judge later. One of my old law partners has a saying that rings true every time I file a lawsuit. He says: “As soon as a client must file a lawsuit, the client has lost.” Lawsuits are a waste of time, money, effort, energy, opportunity, etc. One key to making money in business is to make every deal a success. Win-Win scenarios are always better than win-lose relationships. Another related key to business success is to avoid expensive disputes.

Applying those principles to lease-options, it is important that the landlord document his intentions as to an option agreement whenever a tenant breaches a lease. If a tenant is a few days late on rent, that is a breach, and the landlord should send a letter to the tenant indicating that the landlord has terminated the option, or is willing to waive the default as to the option that time. If the lease or option agreement requires a written notice from the landlord to the tenant in order to terminate either the lease or the option, then the landlord must make sure to follow the requirements of the written agreements. So many landlords fail to follow their own agreements. Yet, it is so very easy to send a letter or other written notice to the tenant and avoid any problems in the process.

“As soon as a client must file a lawsuit, the client has lost.”
CHAPTER 5
Exit Strategies

*Exit Strategies and Credit Problems*

The transaction documents should describe what will happen if the tenant defaults on the lease, fails to exercise the option, or is unwilling or unable to close on the purchase after exercising the option. If the tenant is to use bank financing, then generally the option fees will be forfeited to the landlord if the tenant does not close on the purchase for any reason. However, if the landlord is providing the financing, another credit report should be required immediately prior to closing as a condition of the financing. If the tenant then does not have good credit, the landlord must have the right to refuse to provide the financing. If the deal then does not close because the tenant is unable to find other financing, the tenant is likely to be very upset unless the tenant clearly understood the risks. Of course, there is nothing to prevent the landlord and tenant from negotiating a new deal if the old one does not close.

*Small Claims Court*

Indiana small claims courts have limited jurisdiction, meaning that these courts can only do certain things and hear certain cases. As of January 2014, Indiana small claims courts are limited to two types of cases: landlord-tenant disputes and cases involving disputes of $6,000 or less. Marion County Small Claims Courts have jurisdiction over cases involving $6,000 or less, exclusive of attorneys’ fees. Indiana small claims courts cannot order foreclosure. So, if a lease-option dispute is viewed by a small claims court judge as a land contract case requiring foreclosure, the case must be transferred to another court. That results in a delay in the eviction of months or possibly years. In Marion County, some small claims court judges refuse to hear any landlord-tenant case, if there is an option agreement between the parties. Those cases automatically are delayed and get sent to the Marion Superior Court, where the court rules are more complicated and a lawyer is usually required to represent the landlord. This is just another reason why it is so important properly to structure lease-options.
“Sweat Equity” Side Deals

Often, landlords will sign lease-option agreements with tenants, expecting the tenant to make significant repairs as part of the tenant’s “down-payment.” That approach causes several problems. First, making repairs to a building do not neatly fit into a lease or option agreement. Secondly, that is a taxable transaction, and the failure to report that transaction is tax evasion. Thirdly, landlords do not properly document that tenant’s agreement to make repairs. Fourthly, these “sweat-equity” deals look more like purchase terms, rather than leases. In short, these deals are usually a mess and rarely documented properly. Avoid “sweat-equity” deals, and seek help from an attorney if you insist on doing such a deal.
CHAPTER 6
List of Important Documents

The following is a short document checklist, which a landlord/seller may find useful:

Lease Application
Credit Reports/Tenant Screening Reports
Employment Verification
Bank Verification
Lease Security Deposit
Lead-based Paint Disclosure
Lead-based Paint Booklet
Seller’s Residential Real Estate Sales Disclosure
Option to Purchase
Sample Purchase Agreement
Sample Warranty Deed
*Sample Note (unsigned)
*Sample Mortgage
Notice by Tenant of Exercise of Option to Purchase
*Second Credit Report
Title insurance commitment
Notice by Owner of Changes in Property Condition
Appraisals, inspection reports, etc., as required by lender
Settlement Statement
Signed and recorded Deed
*Signed Note
*Signed Mortgage
Disclosure of Sales Information
Record Deed and *Mortgage
*Mortgagee’s Title Policy

(*used when landlord is providing financing to tenant)
Conclusion

In general, lease-options can enable a landlord to sell a property at a price on the high end of fair market value to a buyer who presently does not qualify for third party financing but is likely to qualify after the end of the lease term. The landlord can also collect an option fee at the time the lease is signed and additional option fees during the life of the option. The option fees compensate the landlord for keeping the property off the market during the option term and improve cash flow. The tenant gains access to a property worth purchasing and prepays, essentially, a part of the down payment. This gives the tenant a good reason to remain current on the lease and close on the purchase.

It would be a shame, if large numbers of poorly written lease-options influenced the courts to treat every lease-option agreement as a land contract and thus, a note and mortgage, because that harms both landlords and their tenant-buyers. So, I encourage all landlords carefully to reconsider how they draft their lease-options.

In the end, lease-options remain a great way to sell real estate. Lease-options, if structured and written properly and fairly, are a win-win both for the tenant-buyer and landlord-seller. By avoiding unfair or poor lease-option structures and strategies, lease-options can still be a great way to sell real estate and give a tenant with bad credit the opportunity for home ownership.

As with any complicated transaction, changes in the facts and circumstances of a case will cause the need to alter standard form documents, so be alert to opportunities and issues. As always, feel free to contact this author for specific answers to your questions or for a consultation. Good luck and Happy Real Estate Investing.
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Matt is the founder and Senior Attorney at Griffith Law Group LLC, an Indianapolis law firm. He focuses his practice on business, real estate and estate planner matters. Matt’s practice emphasizes practical solutions that are preventative in nature and that serve to maximize his clients’ opportunities, while minimizing risks.

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Matt is an entrepreneur, investor and business owner himself. Those experiences enable him with a unique perspective to identify and serve the needs of his business and real estate clients. Matt provides executive coaching services as well as general business counsel to a wide range of business owners and their companies.

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