Lease-Option or Installment Sale?

By Spencer Roane

The following is a post by MHC Investor /Operator Spencer Roane on Linked-In in August of 2013

Some/many/most states do not consider Lease-Option (L-O) transactions mortgages and, therefore, not subject to SAFE Act licensure (MLO, MB, or ML). Since terms like L-O were loosely defined before the SAFE Act, there's still a good bit of confusion about what a L-O transaction is and how it should be structured. Incidentally, while L-O is understood to be a "lease with an option to purchase", Lease-Purchase is a lease with an obligation to purchase, and Rent-To-Own involves equal payments until ownership is transferred. Both of the latter two transactions are generally considered credit transactions (ie – installment sales) .

Here is my understanding of the highlights L-O transactions involving manufactured homes (MHs) in land lease lifestyle communities. A L-O transaction is less likely to be considered an installment sale if it has the following characteristics:

• The lessor essentially owns the asset until lessee exercises the option.
• The Option Payment (amount paid up-front for the option, or right to purchase) must be a significant portion of the value of the asset (so don't make the Option Payment $1 or a "security deposit").
• Lease payments don't substantially exceed the fair market rental of the asset.
• No portion of the lease payments apply toward purchase of the asset.
• The Option Price (amount paid to purchase the asset once the option is exercised) is about equal to the fair market value of the asset at that point in time – not a nominal amount or simply the last lease payment.
• No "side deals" or hidden agendas/incentives exist between lessor and lessee.

When L-O transactions involve manufactured homes, the concern that the option price might resemble a loan balloon payment would seem to be addressed by the depreciating value of the MH, documented by experience, chattel valuation services (eg – NADA), and agreement by lessor and lessee at inception of the L-O agreement that the option price approximates fair market value of the MH if/when the option is exercised.

Recognize that the SAFE Act is federal legislation which is interpreted differently by different states. Hence, what's acceptable in one state may not be in another. Hopefully the info I provide will allow a CO and his/her attorney (since I can't underline, I'll repeat "and his/her attorney") to efficiently consider L-O in the state(s) in which his/her communities are located and, hopefully, develop an L-O program that works for him/her.

Although not discussed in this article, one might recognize that lessor might choose to finance the option price (once lessee exercises the option). Since a "mortgage" is frequently defined as an installment sale where lender holds a security interest in the asset (or "dwelling", as defined in the SAFE Act), one might avoid creation of a mortgage by surrendering the MH title to the buyer/borrower, replacing that security interest with an unsecured promissory note from the borrower. Lessor might justify relinquishing the title based on lessee's payment history and the cost of relocating the MH.

The History

There's nothing odd about seller-financing. It's been around as long as there have been buyers and sellers. And as long as we've had seller-financing we've had variations of seller-financing: installment sales, contracts for deed, land contracts, lease-option, lease-purchase, rent-to-own, and dozens more.

If we accept "abnormal" as the definition of "odd", one thing that is odd is that the old way of managing land lease communities (fka mobile home parks) hasn't worked for the better part of 10 years. Stupid, greed-driven easy chattel financing cast a mold 20 years ago that was clearly destined to decimate all aspects of manufactured housing. When the smoke cleared, production of MHs had fallen to precariously low levels, there was no chattel financing left, and most street retailers were out of business. Another staple of LLCs, pre-owned finance company repossessed MHs, soon disappeared too.

COs were forced to get into the business of buying, financing, and selling new MHs. Community offices, which used to only exist to collect rent, turned into sales centers. Onsite personnel, who used to only deal with resident problems, became salesmen (and women). Higher priced sales transactions required COs to fine-tune seller-financing.

The same sloppy financing that decimated manufactured housing also decimated site-built housing, and gave us the S.A.F.E. and Dodd-Frank Acts. We either learned firsthand or from others how difficult, if not impossible, it became to continue providing installment sale seller-financing. Depending on the state(s) in which we operate, lease-option sometimes proved to be a viable alternative. By the way, there's nothing wrong with saying we chose an alternative to avoid onerous licensing and compliance requirements – just as tax avoidance is legal, while tax evasion is not.

Lease-option is no different from all viable alternatives today's COs must routinely consider to operate their business as efficiently and profitably as possible – including catering to different market segments (boomers, singles, etc.), renting vs. selling MHs, different size homes, different price point homes, different marketing ideas, new sales training programs, better sales lead tracking, new management software, etc. Instead of "topsy turvy", I prefer "making lemonade out of lemons".