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Bob Aaron bob@aaron.ca

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Rent-to-own deals can be risky business

Last month I received an email from a firm billing itself as a "very successful real estate investment firm that invests heavily in something called rent-to-own."

The e-mail offered several "hot deals" that were "going fast." Three were on behalf of "high income" tenants now looking to buy a home in or near Toronto, and one was an offer to sell a "premium Mississauga lakeshore rental" home with tenants already in place.

The offers promised annual returns of 20.98 to 26.72 per cent to investors who would buy the properties and lease them to tenants with an option to purchase at a fixed price anywhere from one to five years down the road.

The rent-to-own option is also known as lease option. It consists of an agreement which combines a lease with an option to purchase at some time in the future.

The concept is said to appeal to tenants with a problematic credit score, but enough cash on hand (say $10,000) to pay for the option. The investors use the tenant's option fee as part of their down payment and collect "above market" rent until the tenant is in a position to obtain financing and purchase from the investors.

Tenants can lock in a purchase price in a rising market and can freeze their rental payments for as long as five years.

The pitch to investors is that they can invest in rent-to-own properties which offer "low risk, high returns, hands-off investments that build substantial wealth fast."

Unfortunately, that's simply not true. The rent-to-own concept presents significant risk both to sellers/landlords and buyers/tenants.

Perhaps the most significant challenge is that there are no standard lease purchase agreement forms accepted by the real estate industry, and the commonly-used templates that I have seen in my practice leave a great deal to be desired.

Trying to determine an option price for a transaction taking place in three to five years in the future is largely guesswork. If the price is too high on the option date, the buyer will back out, and if it's too low, the seller will walk away for potential additional profit.

As well, tenant buyers may be paying more than market rent so that each month some money will be credited against the eventual purchase price. If the buyer backs out at the expiry of the lease option, he or she will lose the option fee and any monies paid along the way as a credit against the purchase price.

Buyers may also be exposed to unlicensed real estate agents like the ones who sent me the marketing email last month, or to unscrupulous sellers. Back in September, 2008, the *Toronto Star* reported on Solution Homes, the operators of a rent-to-own scheme who leased houses from desperate sellers, subleased them to tenants, pocketed the rents without making mortgage payments, and left the tenant buyers to be evicted by the mortgage lenders.

For investor sellers, the worst case scenario is when the tenant buyer goes into default. The Landlord and Tenant Board has ruled that it does not have jurisdiction to evict a defaulting tenant who has an option to purchase. Power of sale and foreclosure proceedings cannot be used, and landlord sellers are forced to take defaulting buyers to Superior Court to evict them and terminate the option agreement. This is what happened in the case of Novotny v. Fowler where the parties retained lawyers and experienced significant delay and expense to unwind their rent-to-own deal when the buyer defaulted.

In his 2010 book, *Investing in Rent-to-Own Property,* Mark Loeffler significantly downplays the risks involved in a worst-case scenario. His simplistic answer, for example, to the defaulting tenant problem is to check out the tenant's credit and require post-dated cheques for the entire term, which is prohibited under Ontario law.

Rent-to-own is not for everyone. For both sellers and buyers it involves a significant amount of risk. Participants in the program should only deal with licensed real estate agents and with real estate lawyers who are familiar with the concept.

Bob Aaron is a Toronto real estate lawyer and consumer advocate. He can be reached by email at bob@aaron.ca, phone 416-364-9366 or fax 416-364-3818.
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