THE LONG-TERM LEASE AS AN ALTERNATIVE TO HOME OWNERSHIP: A PROPOSAL

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Home ownership has long been a prime element of the American dream. Following the recent recession, there is currently a nationwide boom in the construction and sale of single-family housing units.[1] However, it has been reported that a significant number of prospective first-home buyers are unable to buy because housing prices are rising faster than incomes.[2] Some families have been able to buy homes only by changing their living patterns significantly.[3] While it may be questioned whether the current financial squeeze on home buyers is worse today than in the past,[4] it appears to be severe

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1. Wash. Star, June 26, 1977, § A, at 6, cols. 4-5; Wall St. J., May 24, 1977, at 1, col. 6 (eastern ed.).

2. Wash. Star, note 1 *supra*; TIME, Sept. 12, 1977, at 50.

3. *See* TIME, note 2 *supra*. The Washington Star reported that the category of home buyers 20 to 35 years old has more working wives. Further, 25 to 30% of income is devoted to house payments compared to 20 to 25% in the past. These higher payments put the first-time buyer in a financially precarious position, especially if one of the two paychecks were lost. Many buyers have had to lower their expectations as to house quality. In addition, higher than average housing costs in certain areas have caused some people to move to other areas with comparatively lower housing costs, forcing some buyers to commute long distances to work. Wash. Star, note 1 *supra*.

4. Michael Sumichrast, Staff Vice-President and Chief Economist, National Asso-

enough[5] to make exploration of ownership alternatives appropriate. This essay suggests that the long-term lease be utilized to bring many of the amenities of living in a detached, single-family dwelling within reach of persons who presently find the purchase of such a home prohibitive.

Any ownership alternative must embody a great number of the perceived advantages of ownership if it is to be embraced by significant numbers of people. To a large extent, identifying features of home ownership as advantageous or disadvantageous is a matter of individual opinion. Yet, while individual assessments may vary, the concerns of most prospective buyers can be identified generally as financial, use, social considerations, or some combination thereof. For example, a person might want to purchase a home because of the income tax deduction generated by paying mortgage interest and real estate taxes, or because of a substantial gain in the market value of the home that occurs over time—a gain accentuated in relation to the equity of the purchaser by the fact that a heavy proportion of the purchase price would be borrowed. All these are "financial" considerations.

But the individual, by hypothesis, wants only to buy a detached, single-family dwelling rather than a townhouse or a condominium apartment unit. This preference for a detached, single-family dwelling as an object of ownership suggests that use or social advantages are perceived by the prospective purchaser. The individual may enjoy developing and maintaining a lawn or garden, living apart from neighbors, living with greater interior space, providing an outdoor play area for children or pets—all of which seem to be "use" advantages. Or the person may believe that living in a single-family dwelling allows more gracious entertaining of friends—a combination of use and social advantage. Social advantage may be combined with financial advantage for those persons who see ownership and resi-

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ciation of Home Builders, points out that opinions of economists are divided on this question. He concludes that middle-income people are able to buy homes and are doing so, and that there has been little change in the gross income share they pay for housing today compared to that of the past. Wash. Star, June 4, 1977, § E, at 1, col. 1.

5. The item in the Washington Star closes on a sombre note: "For all the young families who are managing to buy their own home, there are many—particularly in one-salary blue-collar families—who are looking at the housing market and despairing. If present conditions continue, some housing experts believe the large number of baby-boom generation Americans priced out of the American dream could become a political force to be reckoned with." Wash. Star, note 1 *supra*.

dence in a detached, single-family dwelling as a mark of attainment and respectability in the community.[6]

There are also disadvantages in owning a home. A large down payment and closing costs at purchase drain the buyer of ready cash, and large monthly payments thereafter may make rebuilding the buyer's bank balance a slow process. If the home is new, carrying charges often exceed the rental value of the home. If so, the purchaser sustains expenses without any compensating current income. Any income tax savings created by a portion of the monthly payments may substantially reduce the net expense but it will not eliminate it,[7] much less provide a positive return. In making the down payment the purchaser foregoes current income that could have been received from a different investment, since no financial return is realized until the house is sold (hopefully at a profit).[8] A home purchaser who later experiences a permanent drop in income may be unable to properly maintain the home or the carrying charges, thus exposing the large investment to partial or total loss and perhaps threaten personal liability on a deficiency judgment remaining after

6. *See* U.S. NEWS & WORLD REP., April 25, 1977, at 86. After stating that the financial advantage of buying "is not as clear-cut as most people think, if all the buyer gets is title to the same kind of home he would rent," the author concludes, "Finally, there is an intangible factor: pride of ownership. It is this, as much as anything, that has made it possible for the housing industry to convince about two-thirds of American families that it is better to buy than to rent." *Id.*

7. Since the tax saving is only a portion of the deductible expenditure, to eliminate the net expense the buyer would have to pay a state income tax as well as a federal tax *and* be in marginal tax rate brackets under both systems that total 100%. As of December 1, 1976, the highest state marginal rate was imposed by Delaware—19.8% on income above $100,000. [1977] ALL STATES TAX GUIDE (P-H) ¶ 228; [1977] STATE TAX HANDBOOK (CCH) ¶ 310. Vermont took a flat 25% of the federal tax plus a 9% surcharge, resulting in a tax rate of 27.25% of the federal tax. *Id.* at ¶ 880. Neither rate equals 100% when combined with the highest federal rate of 70%. The net expense might be eliminated for some taxpayers in high marginal brackets if one assumes they would otherwise have invested the funds, now tied up in down payment and closing costs, in a manner that would have created taxable income. One would then have to take into account the tax which would have been paid on the alternative investment as well as the tax saved through deductions generated by home ownership in determining whether the net expense was cancelled. However, it seems realistic to assume that a high bracket taxpayer would invest in tax exempt securities.

8. While the amount will obviously vary with the price of the house and the terms of payment, the foregone income is likely to be substantial. For example, in surburban areas of Washington, D.C., it is not uncommon to encounter a total figure for down payment and closing costs of $20,000-$25,000 for a new home. At 6% interest the income of such a fund would be $1,200 to $1,500 annually.

foreclosure. Finally, it is more difficult for an owner than for a tenant to move away if unpleasant changes in the neighborhood occur, a disadvantage that involves each of three factors—use, social and financial.

A long-term lease would give the tenant almost all the use advantages of ownership. Whatever social disadvantages presently attach would largely disappear as leasing becomes a common mode of holding one's home. Under existing law the tenant could not participate in all the financial advantages of ownership, but, on the other hand, neither would the tenant be exposed to all its financial disadvantages.

TERMS OF THE LEASE

A lease term of twelve years would afford about the same degree of permanence in residence now achieved through outright purchase.[9] The tenant given a right of first refusal of successive terms would gain an additional element of stability, at least as long as the landlord continued to rent the property. A fixed rental for the life of the lease would be most desirable since this would stabilize housing costs for the tenant in the same manner that the traditional fixed payment mortgage stabilizes costs for a purchaser. Expectations of inflation are sufficiently high that a provision for periodic rent escalation may prove necessary to induce prospective landlords to enter into long-term leases at rents not unacceptably higher than other current rentals. An appropriate compromise might be to allow inflation rent adjustments on the fifth and tenth lease anniversaries, and whenever a lease is renewed. Landlords could protect themselves during each five-year period by charging a higher rent than that imposed in comparable short-term leases, and tenants would still benefit from stabilized housing costs. In some localities the solution may be simply to

9. It is difficult to estimate the average length of time an owner remains in a particular home. The period stated in the text was extrapolated from a report that 8 1/2% of homeowners in the United States moved during the year 1975. CENSUS BUREAU, U.S. DEP'T. OF COMMERCE, ANN. HOUSING SURVEY: 1975, pt. D, at 1 (1975). In some communities owners move much more frequently. In the Washington, D.C., area owners may move as often as every three to five years. Telephone interview with Ed Wine, Director, New Home and Condominium Sales Division, Town & Country Properties, Inc., Fairfax, Virginia (December 7, 1977). Thus it appears that a much shorter lease term than twelve years could equal the permanence of buying. Whatever the owner occupancy time in a particular community, it is evident that the social and use differences between owning and renting today are not nearly as great as in the days when owning families lived in the same house for generations.

shorten the lease term to five years.[10]

To emphasize the independence and freedom of use the lease is intended to give the tenant, a clause characterizing it as a conveyance as well as a contract should be included. To the same end, the tenant should not be limited in the right to assign or sublease. The lease might give the tenant complete discretion in dealing with the property except as limited by other clauses in the lease. Accordingly, the tenant should be made responsible for all maintenance, taxes and utility costs, since these responsibilities follow logically from having a relatively independent status. By removing expenses of uncertain magnitude from the landlord, a tendency toward lower rent would be created.[11] Indeed, if such expenses were not placed on the tenant, it is almost certain that prospective lessors would insist on substantial periodic rent increases to compensate for anticipated cost increases. In addition, making the tenant responsible for maintenance gives those tenants who are able to make the repairs themselves the financial benefit of their own work.

To stablilize a tenant's maintenance costs, to assure that the maintenance would in fact be performed as needed, and also to assure that rent would be paid as agreed, a combination of performance bonds, insurance coverages, and a right of inspection should be provided. The lease should require the lessee to provide the lessor a bond for rental payments plus reasonable costs of re-letting if the lessee should breach the lease and be evicted or abandon the lease. The lessor in such circumstances should be required to make reasonable efforts to re-let the premises. To assure a real effort by the lessor to re-let, the bond should state the maximum number of months' rent it guarantees. Once the lessor entered into a new lease at a reasonable rental, if the rent under the new lease were less than that under the old the lessor should be paid the value of the difference for the period between the inception of the new lease and the expiration date of the broken lease. Conversely, credit should be allowed to reduce the liability of the bonding company whenever the rent under the new lease is found to be greater than the rent under the old.

The bond, of course, represents a substantial commitment by the tenant. In addition to paying the premium itself, the tenant may ex-

10. *See* note 9 *supra.*

11. It seems fair to assume that, to the extent market factors permitted, a landlord would put a generous estimate on an unknown cost factor and add a profit factor as well.

pect to give the bonding company collateral and incur a personal obligation to indemnify the company against loss on the bond. Apart from the premium, however, the costs the tenant incurs are only potential and can be avoided merely by paying the rent. Even if default should occur the costs represent the same liability[12] the tenant would owe the landlord if there were no bond. Although posting collateral is a nuisance, since that collateral is no longer freely available to discharge other liabilities the tenant may incur, the tenant may often continue to obtain benefits from the collateral. Bonding companies satisfied with the collateral assets will generally allow the tenant to continue receiving whatever income the assets produce and to substitute acceptable collateral, thereby preserving the ability to sell and buy investment assets. The amount of the bond premium is difficult to anticipate. One may speculate that it will be affected by the experience of the bonding companies in paying defaulted rent and in recovering indemnification, and that future premium costs will be lower as companies develop experience in long-term lease bonding.

Maintenance insurance, modeled after the Home Owners Warranty Program of the National Association of Home Builders,[13] could cover structural defects, faulty workmanship and defective materials in the plumbing, heating, cooling and electrical systems. The tenant should be required to give the landlord a bond to assure that other maintenance would be properly performed. The lease should also provide for periodic inspection of the premises by an architectural board or other disinterested party knowledgeable in the building trades, and should make the decision of that third party binding on both landlord and tenant as to the need for maintenance. The lease might further provide that thirty days after the tenant has been notified of particular work to be done, the third party should contract for the work at the tenant's expense unless the tenant has either started the work or contracted for its performance. Both the bond and the cost of maintenance inspections should be paid by the tenant since they are devices for assuring actual performance of a tenant's maintenance responsibilities.

The lease should require the tenant, before making capital improvements, to protect the landlord from potential mechanics' and

12. 1 AMERICAN LAW OF PROPERTY § 3.99 (Casner ed. 1952).

13. *See e.g.*, HOME OWNERS WARRANTY COUNCIL OF MISSOURI, AN IN-DEPTH REVIEW OF THE HOME OWNERS WARRANTY PLAN (1977).

materialmen's leins. If adequate protection is provided, the tenant should be allowed any increase in the value of the leased premises attributable to improvements accrued to the time the tenant gives up the dwelling. The tenant should have title to the improvements until the landlord makes payment, as described below. Thus the tenant would share in gains flowing from his own capital improvements, as well as having their use and enjoyment during the tenancy. Assuring tenants of participation in resulting gains would incidentally create an incentive to maintain and improve the premises.

The value of the capital gain might be determined by requiring appraisal of the property within, perhaps, thirty days of execution of the lease. As part of the appraisal, the existing capital items would be listed. A tenant making improvements would be entitled to have a similar appraisal made upon giving up possession with a determination by the appraiser of the portion of any gain experienced attributable to tenant improvements. The figure stated would be due the tenant, in cash if the tenant had not defaulted under the lease or as a credit against any liability if the tenant had defaulted. In the latter case any surplus existing after liquidating the liability would be paid in cash. The improvement gain should be made a lien on the premises until paid. To eliminate suspicion of appraiser bias, the lease might provide that the appraiser be selected by a third party from the professionally accredited appraisers in the community. The parties to the lease should agree to share appraisal costs equally and to abide by the appraisal results.

SUGGESTED LEGISLATION

It is unlikely that owners will be interested in the long-term lease if all the new court-created liabilities are held to apply. The implied warranty of habitability has been held by an intermediate Missouri court to be part of every residential lease.[14] Although that case in-

14. King v. Moorehead, 495 S.W.2d 65, 75 (Mo. App. 1973). Courts in many states have recognized an implied warranty of habitability. *See, e.g.*, Javins v. First Nat'l Realty Corp., 428 F.2d 1071 (D.C. Cir. 1970), *cert. denied*, 400 U.S. 925 (1970); Hinson v. Delis, 26 Cal. App.3d 62, 102 Cal. Rptr. 661 (1972); Givens v. Gray, 126 Ga. App. 309, 190 S.E.2d 607 (Ct. App. 1972); Lemle v. Breeden, 51 Hawaii 426, 462 P.2d 470 (1969); Jack Spring, Inc. v. Little, 50 Ill.2d 351, 280 N.E.2d 208 (1972); Mease v. Fox, 200 N.W.2d 791 (Iowa 1972); Reed v. Classified Parking System, 232 So.2d 103 (La. App. 1970); Kline v. Burns, 111 N.H. 87, 276 A.2d 248 (1971); Reste Realty Corp. v. Cooper, 53 N.J. 444, 251 A.2d 268 (1969); Glyco v. Schultz, 35 Ohio Misc. 25, 289 N.E.2d 919 (Ohio Mun. Ct. 1972); Pines v. Perssion, 14 Wis.2d 590, 111 N.W.2d 409 (1961). *See generally Developments in Contemporary Landlord-Tenant*

volved a month-to-month tenancy with no explicit allocation of repair responsibility, there is little in the opinion to suggest that an exception would be made for a long-term lease that expressly placed maintenance responsibilities on the tenant.[15] Perhaps the provision for tenant participation in capital gains, in combination with the other suggested provisions designed to make the lessee more nearly an owner, would persuade a court to carve out such an exception. The matter now is doubtful.

In some situations lessors have been held liable for tortious conduct of the lessee,[16] for conditions on the premises that cause harm,[17] and for harm to the tenant caused by criminal conduct of third persons.[18] Legislation is the most appropriate method of exempting the long-term lessor from these liabilities, but the lessor can obtain some protection through insurance and can take steps to reduce the frequency of claims. Diligent inspection may assure that the tenant has not permitted a nuisance or a potentially hazardous condition to arise. Liability for criminal acts of third persons may mean that, as a practical matter, the proposed lease is not feasible in high-crime areas.[19]

Law: An Annotated Bibliography, 26 VAND. L. REV. 689, 727-31 (1973); Annot., 40 A.L.R. 3d 646, 653-57 (1971).

15. However, the court mentioned that the Missouri Supreme Court had approved criticism of the common law rule placing the duty of repair on the tenant ". . . in the absence of a specific covenant." King v. Moorehead, 495 S.W.2d 65, 71 (Mo. App. 1973) (quoting from Minton v. Hardinger, 438 S.W.2d 3 (Mo. 1968)). Perhaps the quote from the *Minton* case implies that a convenant explicitly placing the duty on the tenant would be upheld. *Minton* arose from the rental of a furnished apartment for one month.

16. *See* W. PROSSER, LAW OF TORTS 402-03 (4th ed. 1971). The liability of the landlord, as an exception to the general rule, has only been found where the activities of the tenant were "consented to at the time of the lease, and which (the landlord) should have known would necessarily involve such a result." Perhaps the exception will swallow the general rule. *See* note 17 *infra*.

17. *See* Annot., 64 A.L.R.3d 339 (1975). A New Hampshire court recently abolished the limited immunity from tort liability that landlords have traditionally enjoyed, and imposed a standard of reasonable care to avoid subjecting persons to an unreasonable risk of harm. Sargent v. Ross, 113 N.H. 388, 308 A.2d 528 (1973). Although *Sargent* involved a dangerous stairway located on the premises, the court intended to impose a general liability for negligence on landlords.

18. Kline v. 1500 Massachusetts Ave. Apt. Corp., 141 App. D.C. 370, 439 F.2d 477 (1970) (involving the lease of one unit in a large apartment building). *See* Annot., 43 A.L.R.3d 331 (1972).

19. Kline v. 1500 Massachusetts Ave. Apt. Corp., 141 App. D.C. 370, 439 F.2d 477

The possibility that an implied warranty of habitability may be imposed on the lessor is the most troublesome. Application of the warranty strikes at the practicality of the proposal. It would expose the lessor to inflationary risks that probably would make it financially imprudent to enter into long-term leases without a provision for periodic rent escalation.[20] It would undermine the independence of the lessee, as well as foster expectations of lessor/lessee confrontations that presently occur under the short-term lease.

Legislative exemption from the implied warranty of habitability appears essential if the proposal is to have a chance for acceptance, although the exemption must be carefully worded to prevent its use as an escape from the implied warranty for lessors of other types of residential leases. Perhaps a rebuttable presumption of no implied warranty of habitability might be created and made applicable to residential leases of detached dwellings where the original term is at least five years. Limiting the exemption to detached-dwelling leases assures that the implied warranty will continue to apply to apartment leases.[21] Casting the exemption in terms of a rebuttable presumption allows courts to imply the warranty in those long-term leases of detached dwellings where it might appear just to do so; for example, where the scarcity of other residential quarters indicates that the tenant was forced to accept a lease on unwanted terms. Designating the original term of the lease as a factor in qualifying a lease for the exemption permits short extensions of the term without automatic loss of the exemption, thereby allowing the parties freedom to tailor extensions to their own preferences. At the same time the tenant remains free to rebut the presumption with facts arising during the exemption period. Making the critical length of term five years rather than twelve makes the proposed lease available to tenants who expect a less-permanent residence than the average experience, and to owners who are unwilling to lease property for a term as long as twelve years but do not object to a shorter term.

Home ownership receives substantial subsidies from the federal

(1970), based liability in part on the lessor's knowledge of the prevalence of crime in the area.

20. *See* text accompanying note 10 *supra*.

21. Apartment leases provide the strongest justification for the implied warranty because of the frequency that maintenance operations involve work in areas outside the control of tenants, and in terms of a relative financial ability of the landlord to pay for the work.

government.[22] The proposed long-term lease of detached, single-family dwellings could also be subsidized. Congress could authorize federal payment[23] of some portion of the appraisal, bond, or insurance expenses, thereby lowering the tenant's expenses to a figure more nearly approximating those of a tenant of comparable property under a traditional lease. Congress could make the proposed lease even more attractive by allowing the tenant an income tax deduction for any real estate taxes the tenant is required to pay.[24] No change in the present tax law is needed to allow profits on tenant improvements to be treated as capital gains since they would be "sold" to the landlord.

CONCLUSIONS

By eliminating the capital investment, the mode of home holding outlined above may effect a significant reduction in cost and an improvement in financial liquidity for the resident-tenant compared to that currently experienced by home purchasers. At the same time it may provide many of the advantages now perceived in home purchase, including the opportunity for gains on any investment of captial that the resident chooses to make. Although the costs will be higher than those of a typical tenant leasing residential property, the increase may be viewed as the price of the larger independence and near-ownership the proposed alternative affords. Further, Congress has the power to reduce or eliminate the increase, if it chooses, by subsidizing the tenant.

Persons who now own residential property may also find the proposal an attractive alternative to sale since it could offer them a reduction in costs. The realtor's fee for finding a tenant is less than for finding a buyer, and because no financing is needed there is no

22. For example, payments for mortgage interest and real estate taxes are deductible for income tax purposes. George Romney, then Secretary of Housing and Urban Development was quoted as saying, "Maybe we ought to repeal part of the right to deduct the interest rate from the income tax return to bring home to middle-income and affluent families that they are getting a housing subsidy." N.Y. Times, Oct. 24, 1969, at 18, col. 5.

23. The payment might take any of several forms, including providing services through federal agencies to tenants at a lower rate than private firms would charge, reimbursing a portion of the tenant's costs, or granting a tax deduction or tax credit.

24. Presently the deduction is allowed for the person on whom the tax statute places the obligation of payment. Rev. Rul. 75-301, 1975-30 I.R.B. 8.

chance that the seller would have to pay the lender "points."[25] The owner who adopts the proposal postpones sale, which is likely to result in a greater capital gain when a sale is finally made. Further, it materially reduces carrying charges, and achieves substantial assurance that rent will be paid and maintenance performed during the rental period. The obligation to pay the capital gain attributable to tenant improvements when the lease ends, while it may deter some owners, is really only the price of reaping the future gains which the improvements enjoy. As such, it may be viewed as a bargain. Offering advantages to both the prospective resident and the owner, the proposed mode of home holding may be a practical way for many to achieve the amenities and stability of the American dream in housing at a relatively low cost.

25. Maximum permissible interest rates on mortgage loans are set by the Federal Housing Administration and by the Veterans Administration with respect to loans they insure or guarantee, and by state governments through usury legislation. In many localities the market rate of interest is higher than the legal rate. To bring the effective interest on a loan up to the market rate without violating the legal rate, lending institutions have developed the practice of "discounting" or lending a lesser sum of money than the borrower must repay. The difference between the amount loaned and the amount to be repaid is expressed in "points"—a point being 1% of the face amount of the note. Since regulations of both the FHA and the VA prohibit charging the discount to the borrower, the seller pays in those sales where the FHA or the VA are involved. Of course, the seller tries to pass the cost to the buyer by a higher selling price than would otherwise be acceptable. *See* G. NELSON & D. WHITMAN, CASES AND MATERIALS ON REAL ESTATE FINANCE AND DEVELOPMENT 504-08 (1976). *See also* T. WALL & C. ZWISLER, SURVEY OF STATE USURY LAWS (1975).