Contracts that Offer Cash for Home Equity Are Riskier than They Look

April 2020

American homeowners are estimated to collectively have billions of dollars of equity in their homes. But the recent COVID-19 crisis could leave many desperate for cash—either to avoid foreclosure or for other expenses. Older Americans who have lots of equity after paying down their mortgages may be especially at risk. Some investors say a new twist on an old tool—shared equity—can help people turn that equity into cash without a loan. But how does that work and is it safe?

HOW SHARED EQUITY IS DIFFERENT

The traditional way to turn home equity into cash, without selling your house, is to mortgage it. A mortgage company loans you cash up front, and you promise to repay it in installments. The arrangement is based on the idea that the equity you have now will protect the lender if you don't pay. You're required to repay the loan no matter what happens to the value of your home. If you don't pay, the lender can foreclose on your house and recover the amount owed on the loan by selling the house. In some states the lender can also sue you for any remaining balance. There are laws in place to protect homeowners from certain unfair mortgage lending practices, and many states regulate foreclosures carefully.

But some companies offer to give you money now in return for a share of the equity they think you may have *in the future*. You aren't required to make any payments until a deadline set by the contract. At that time, the company will calculate how much your equity has grown since the start of the contract and you must pay it a percentage of that amount. For example, if your home was worth $200,000 when you signed the contract and it's worth $500,000 at the end of the contract, you will be required to pay the company a percentage of $300,000. The company may advertise that it's not a loan and that you won't owe anything if your home loses value. But the contract terms may conceal important surprises.

What happens if you can't pay when the time comes?

These contracts normally have a deadline. When the time comes, you must pay the company. Most people will probably do so in one of three ways: by selling the house, by using money from savings, or by getting a traditional mortgage. If you don't't want to move, don't have enough savings, and can't get a mortgage, the contract may authorize the company to sell your house out from under you. The end result is the same as a foreclosure—the homeowner gets evicted. But none of the foreclosure protections available for a traditional mortgage will apply.

How much of your equity can the company take?

It depends on how much you're willing to sell. Homeowners are likely to be attracted by a large payment now in return for a percentage of equity to be paid later. But when the time comes, that may leave the homeowner owing far more than they originally received. One court refused to void a 50-year contract transferring 100% of the future increase in value.[1] And another court enforced a contract that gave the funder a 2,000% return on the amount initially paid to the homeowner.[2] This could be a problem if you were counting on using the equity in your home to do something else—like buy a new house, pay for assisted living, or to fund your retirement.

Can you understand the contract without consumer protection disclosures?

Mortgage contracts are complicated. So state and federal laws require the lender to provide various summaries and highlights to emphasize the most important information. These are normally called "disclosures." Even if you can't understand the whole contract, looking at the disclosures will help you understand how much the loan will cost, how long it will last, and whether you can get a better deal somewhere else. **But shared equity companies are not required to give you any disclosures if the agreements are not considered loans.**

Are they loans or not?

This is an important question but the answer is unclear. It depends on the wording of each contract. If these arrangements are loans, state and federal consumer protection laws will apply. That means the homeowner will get important disclosures before signing the contract, and various laws will forbid certain unfair practices. If these arrangements are not loans, those laws might not apply. Some of these companies say the transactions are not loans because you won't have to pay them anything if your property value goes down. But the companies carefully choose homes that are likely to go up in value, so almost all of their customers will be required to pay a large lump sum at the end of the contract or to sell their home. In practice, it's like a balloon payment on a loan.

RECOMMENDATIONS

For homeowners

There is such a wide range of contracts and arrangements that it is hard to recommend a universal set of consumer protections. So the best advice for any homeowner considering a shared equity transaction is to have a lawyer review it first. Yes, lawyers are expensive, but signing a bad contract could cost you even more.

For regulators

Because these contracts are so complex, it is hard for consumers to understand the risks or spot unreasonable terms. State and federal regulators should take the following steps to protect homeowners:

- Subject these contracts to the same protections as traditional mortgages, especially if they are used to avoid a foreclosure,
- Put a cap on the dollar value of the homeowner's future repayment obligation,
- Mandate a clear explanation of whether the homeowner can be forced out of their home for non-payment,
- Require the funder/lender to give the homeowner a new mortgage at the end of the contract term if the homeowner cannot otherwise repay the debt,
- Ban forced arbitration in these contracts,
- Prohibit excessively long contracts, especially if there is no dollar cap on the repayment obligation, and
- Mandate disclosure of the important terms of the contract, including an APR or other cost measurement.

Questions? Please contact National Consumer Law Center staff attorney Andrew Pizor at (consumerlaw@nclc.org).

ENDNOTES

[1] Foster v. EquityKey Real Estate Investments, 2017 WL 1862527, at *2 (N.D. Cal. May 9, 2017).

[2] The contract provided the borrower with a lower interest rate on a $3,067 loan in return for a 48 percent share of the net sale proceeds in addition to principal and interest. When the contract was challenged roughly 15 years later, the lender's share was worth $65,000. Comstock v. Steinbergh, 2004 WL 3120554 (Mass. Super. Dec. 16, 2004) (citing case law approving USDA loss-mitigation contracts allowing 50% and 75% returns). *See also* Trigueros v. Transamerica Corp., 2006 WL 2724034, at *9-*10 (Cal. Ct. App. Sept. 25, 2006) (holding 50 percent shared appreciation fee worth $75,000 after less than three years was not unconscionable for multiple reasons).