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Home Equity Option Contracts Appear Ripe For Rating

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Higher interest rates are making home equity option contracts an increasingly attractive option for consumers who want to tap equity without selling their home, or require liquidity and seek to avoid the incurrence of home equity loans, credit card debt or other debt. And homeowners in the U.S. continue to enjoy historically high levels of home equity.

According to one recent estimate, in the third quarter of 2022, 48.5% of the homes in the U.S. were secured by debt with a total value of no more than 50% of the estimated value of related properties.

Home equity option contracts present consumers with another option for monetizing that equity. Any increase in the volumes of such contracts in the market will require additional capital for providers including from securitizations. Following its securitization debut in 2021, home equity option contract securitizations appear ripe for rating in the near future.

This article first describes how home equity option contracts operate and the differences across product design. We then discuss court decisions that have considered the home equity option product and analyzed the product as a real estate option contract, which then triggers certain regulatory requirements.

We also compare salient features to evolving asset types such as litigation funding, merchant cash advances and income sharing agreements. We conclude that the regulatory requirements associated with real estate option contracts should not be an insurmountable obstacle to rated securitizations.

Product Features

While shared appreciation mortgages have existed for some time, modern home equity option contracts emerged as an increasingly popular product around 2006.

In its simplest form, in exchange for an upfront payment, a homeowner grants an option to acquire an interest in their property. For example, for an upfront payment of $50,000, a homeowner with a home appraised at $500,000 grants an option to purchase 30% of the home for $150,000.

The remaining portion of the option payment is settled at the time of option exercise. The option can be

exercised upon the occurrence of various events during the term of the contract that include sale of the property, the expiration of the stated term of the option — typically between 10 and 30 years — and an optional early settlement elected by the homeowner.

If the property is to be sold for $600,000 after five years, the option holder can acquire its 30% interest in the property for $150,000, having prepaid $50,000 at the time the option was granted.

When the home is sold for $600,000, the option holder receives 30% of the proceeds, i.e., $180,000 and, in this example, realizes a gain of $30,000 — $180,000 minus $150,000.

If the property was sold at a price less than $500,000, the option holder would share in the loss. For example, at a sale price of $400,000, the total payments by the option holder would be $150,000, but the option holder would only receive proceeds of $120,000 and suffer a loss of $30,000, i.e., 30% of the $100,000 excess of the $500,000 appraised value of the home over the $400,000 sale price.

In either case, the homeowner enjoyed the use of the $50,000 upfront payment for five years without an obligation to repay any specified portion of the $50,000 in the future.

Other home equity investment products are styled as forward sale contracts or home equity appreciation contracts but achieve a similar result. For example, in exchange for the right to acquire 15% of the future home value, a homeowner with a home appraised at $500,000 receives $50,000 as an option payment.

If the home is sold for $600,000 after five years, the option holder has the right to receive $90,000 of the proceeds, i.e., 15% of $600,000. Under this contract, the exchange rate would be 1.5, i.e., the 10% upfront payment divided by the right to share 15% of the future value. Upon a sale for $300,000, the option holder would receive $45,000, which represents a loss of $5,000.

Other product features may include a risk adjustment that could typically range between 2% and 25% of the initial appraised value of the property.

A risk adjustment reduces the strike price from which gains or losses are measured. For example, if a property is appraised at $500,000 and is subject to a 20% risk adjustment, the option price would be calculated assuming that the property was worth $400,000.

This risk adjustment provides additional upside potential and downside protection. Features like the exchange rate described above, and any material risk adjustment may be paired with an annual return cap to protect homeowners from exposure to sharing outsized gains with the option holder.

The option holder's rights under the home equity option contract are typically protected by a mortgage or deed of trust that, subject to the rights of any senior mortgage lender, could be foreclosed upon if the homeowner were in material default under the terms of the option contract.

Judicial and Regulatory Treatment of the Product

Real estate option contracts are not a new concept, and case law is prevalent regarding these contracts generally. As home equity option products have become more prevalent in the market, courts also have had occasion to consider the structure of the product and the regulatory characterization.

Consumers have challenged the product as a loan and took the position that federal consumer protection statutes, such as the Truth in Lending Act, or TILA, apply to the product as a form of consumer credit. However, to date, courts have respected the form and function of the product as a real estate option contract and not a loan under TILA.

For example, in Foster v. EquityKey Real Estate Investments LP in 2018, the plaintiff alleged in the U.S. District Court for the Northern District of California that the home equity option contract at issue was a disguised high-cost mortgage originated using deceptive efforts, and asked the court for rescission and damages.

As such, the case squarely posed the question of whether the options were loans under California law, or subject to TILA or unfair to consumers.

Granting a motion to dismiss the plaintiff's claims, the court first examined relevant state law defining real estate option contracts. Analyzing the intent of the parties and form of the contract, the court found that it comported with the state law definition of an option contract, i.e., "a contractual right [held by the option holder] that could become an interest in property when exercised."

The court also held that the contract was not a loan as it did not guarantee repayment of any portion of the upfront payment.

Turning to TILA, the court observed that the federal statute contains an express exclusion for option contracts and investment plans in which the party extending capital to the consumer risks the loss of capital advanced.

Having found the contracts to be real estate option contracts under California law, the court found TILA to be inapplicable to the home equity option product.

In reaching its decision, the court emphasized: (1) the intention of the parties to enter into an option contract; (2) the fact that there was no guarantee that the option price payment would ever be returned or that the option exercise would yield a profit; and (3) the fact that the agreement did not provide title or possession rights to the property.

In December 2022, the U.S. District Court for the Central District of California granted a motion to dismiss in a case against another company offering a home equity option contract similar to the EquityKey product.[1]

In Goldwater Bank NA v. Elizarov, the court, citing to Foster, noted the product was almost identical to the EquityKey product and rejected the plaintiff's characterization of the product as a lending program. The court stated the company's product materials supporting and describing the product "make clear that the Option Agreement was not a loan."

As a real estate option contract, the contract relies on long-standing real property case law and is governed by the terms of the agreement and general contract law. The Foster court described the option contract in the context of real estate as a contractual right that may become an interest in property when it is exercised.

Federal and state consumer regulatory laws also remain applicable to the product. For instance, state law, whether statutory or judicial, imposes requirements on real estate option contracts and the rights

and protections of the parties entering into such contracts.

State laws may specially regulate the contract or define credit or a loan in a manner that is different from the federal TILA. As an example, Connecticut's Mortgage Lenders, Correspondent Lenders, Brokers and Loan Originators Act defines "residential mortgage loan" to include a "shared appreciation agreement," which is defined as

a nonrecourse obligation in which an advance sum of monetary value is extended to a consumer, as a lump sum or otherwise, in exchange for an equity interest in a dwelling, residential real estate or a future obligation to repay a sum upon the occurrence of an event, including but not limited to, the transfer of ownership, repayment maturity date, death of the consumer or as outlined and explicitly agreed to within said agreement.[2]

The Maryland General Assembly also recently adopted legislation that, effective July 1, 2023, amends the definition of "mortgage loan" to include "a loan in which funds are advanced through a shared appreciation agreement."[3] "Shared appreciation agreement" is separately defined in the legislation.

In addition, as a product offered to a consumer, federal and state laws protecting consumers against unfair and deceptive acts and practices implicate how the product is structured, documented and marketed to consumers.

To the extent companies consider a consumer's credit history before entering into a home equity option contract, requirements arise under the federal Fair Credit Reporting Act, to name another example of an applicable law.

If the courts continue to characterize the home equity option contract as a real estate option contract, companies providing these products can identify the regulatory requirements applicable to such contracts and structure a compliance management system for ongoing compliance with these laws.

Home equity option contract securitizations are also subject to the risk that the option contracts could be found to be swaps under the Commodity Exchange Act.

If the option contracts were found to be swaps, the securitization issuer, as owner of the option contracts, could be considered a commodity pool for which a registered or exempt commodity pool operator would be required. If the securitization issuer were a commodity pool, it could also be found to be a covered fund for purposes the Volcker Rule issued under the Dodd-Frank Act.

Similar Products Have Been Rated

While the characterization of, and regulatory requirements applicable to, a real estate option contract are reasonable based on available precedent, courts and regulators have the power to recharacterize an option as a loan, which is an inherent risk associated with such products.

However, that's a risk for various products. As an example, merchant cash advance products involve the purchase of a portion of a business's future receivables in exchange for an up-front lump sum payment.

Courts that have considered the merchant cash advance product treat it as a purchase and sale transaction, and not a loan.[4]

Similarly, plaintiffs have alleged that loan originated through bank partners should be recharacterized

such that the marketplace platform should be considered to be the creditor.

Courts have come up with various test for determining the true lender in such transactions and generally have upheld the characterization of the bank as the true lender.

Such recharacterization risk has not stopped rating agencies from rating products similar to the home equity option contract. For example, third-party litigation funding is a product involving the purchase of a plaintiff's right to proceeds generated from a pending civil lawsuit in exchange for an up-front payment. Again, courts that have considered the product treat it as a purchase and sale transaction, and not a loan.[5]

Comparable to that of a home equity option contract, courts have emphasized that merchant cash advances and third-party litigation funding typically lack an absolute obligation to repay the upfront payment.

Despite a risk that these products could be recharacterized as a loan, rating agencies have given investment-grade ratings to bonds issued in connection with litigation financing securitizations.

Given the similarities with these products, as well as the judicial treatment of the home equity option contract to date, it would seem the home equity option contract is poised to receive similar treatment from rating agencies.

Home equity option contracts represent an exciting development in the residential housing space. Under current market conditions, it is likely that home equity option contracts will continue to grow in popularity in the short-and-medium term.

A rated home equity option contract securitization would greatly expand originators' access to capital and improve liquidity. This in turn will enable originators to meet the growing demand for their product.

Given the ratings for securitizations of asset classes that present similar regulatory issues, we expect such a rated securitization to eventually occur.

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[1] See Goldwater Bank, N.A. v. Elizarov, No. 521-CV-00616-JWH-SPX (C.D. Cal. Dec. 12, 2022).

[2] Conn. Gen. Stat. §§ 36a-485(27), (30).

[3] Md. House Bill 1150 (2023).

[4] See, e.g., Golden Atlanta Site Dev., Inc. v. Nahai, 683 S.E.2d 166 (Ga. Ct. App. 2009).

[5] See, e.g., Ruth v. Cherokee Funding, LLC, 820 S.E.2d 704 (Ga. 2018).