GP|Solo Law Trends & News
Real Estate

September 2007 Volume 3, Number 2

Table of Contents

The Nuts and Bolts of a REX™ Agreement

By Barry A. Abbott and Peter S. Muñoz

Imagine a financial product that allows a homeowner to tap into the equity accumulated in his or her residence without having to take a home equity loan or a reverse mortgage, and without the burden of having to sell the home. This is the idea behind the REX™ Agreement, a relatively new home equity product now available in nine states (California, Colorado, Florida, Illinois, New York, New Jersey, North Carolina, Virginia, Washington). [1] As explained in more detail below, REX Agreements form a financial product that is based upon a real estate purchase option, and which allows homeowners to receive an initial payment of cash, in exchange for giving up a portion of the *future* value of their home. REX & Co. believes this is the first equity (as opposed to loan) product that has ever been available for owner-occupied residential real estate in the United States. The purpose of this article is to explain the legal underpinnings of this new concept to Section members, so as to assist them in advising their clients on this new home financing alternative.

What is a REX Agreement?

A REX Agreement, which is slightly modified for each state's specific laws, is in the form of a coordinated group of four operative legal documents: an option agreement; a covenant agreement; a recorded memorandum of option, list of covenants running with the land and power of attorney; and a recorded security instrument (a deed of trust or mortgage, depending on the state).

By executing the four REX Agreement documents, the homeowner gives REX & Co. a right (an "Option") to buy a specified percentage interest in his or her home (typically between 10% and 50%) at some time in the future for a price ("Option Exercise Price") that is set at the time the REX Agreement is executed. The Option Exercise Price is equal to REX & Co.'s percentage interest times the current value of the home. At the time the homeowner executes the REX Agreement, REX & Co. pays the homeowner three amounts: first, a fee of 0.5% of the Option Exercise Price (“Option Fee”) for granting the Option; second, a flat fee of $1,000 (“Covenant Fee”) for executing the covenant agreement; and, third, a large down payment (“Advance Payment”) on the Option Exercise Price. The Advance Payment is typically between 20% and 30% of the Option Exercise Price. The balance of the Option Exercise Price is paid if, and when, under a defined set of circumstances, REX & Co. exercises the Option in the future, and then actually becomes a part owner of the home (usually in conjunction with the sale of the property as explained below).

The homeowner is not required to repay any portion of the Option Fee, the Covenant Fee or the Advance Payment, or to pay any interest on those amounts, whether or not REX & Co. finally decides to exercise its Option. In addition, the homeowner can use this money for any purpose (although, as discussed below, the hope is that it will be used for asset diversification or major life event purposes). And, while the homeowner has the right to continue living in the home, he or she is not required to pay any form of rent, and should continue to enjoy all the tax advantages (such as, property tax and mortgage interest deductions) of owning the home.

The Option is initially for ten (10) years and, if the Option is not exercised, it can be extended at REX & Co’s request in 10-year intervals for up to a total of 50 years (40 years in Illinois and 30 years in North Carolina). With each extension, REX & Co. will pay the homeowner another Option Fee and another Covenant Fee in the same amount as initially paid.

REX & Co. recognizes that many homeowners have existing home loans secured by the home. The REX Agreements permit these home loans to remain secured by the home as long as they are kept current. REX & Co. also agrees to subordinate it interests to these liens and to any refinancing of these liens for up to 70%-80% of the home’s *original* agreed-upon value.

It is anticipated that typically the Option will be exercised when the home is sold by the homeowner. Upon that sale, REX & Co. can exercise its Option and receive at the time of closing its share of the sale proceeds based on its partial interest in the home. In doing so, REX & Co. will share in any appreciation or depreciation in the value of the home. (Please note that the REX Agreement has been designed for homeowners who intend to remain in their homes for a significant period of time, and if the homeowner sells his or her home in the first five years of entering into the REX Agreement, there is a decreasing “early exit cost” (in the form of a lower Option Exercise Price) which will reduce the amount paid to the homeowner. Typically this “early exit cost” equals 25% of the Advance Payment in the first year. It declines in equal annual increments over five years and is zero in the sixth year and beyond.)

The other circumstances, not involving the home sale, under which REX & Co. will be able to exercise the Option are: (1) the homeowner ceasing to use the property as the homeowner's principal residence; (2) the homeowner jeopardizing the value of the home or REX & Co.'s rights in the home under the REX Agreement; (3) the homeowner permitting a lien on the home other than as agreed to by REX & Co.; or (4) 50 years (40 years in Illinois and 30 years in North Carolina) after the homeowner enters into the REX Agreement (assuming the REX Agreement is still in effect). If under any of these circumstances, REX & Co. should exercise its Option and thus become a partial owner of the home, REX & Co. would then be able to take action as a co-owner of the home and sell the home under a limited power of attorney granted in the covenant agreement. At that time, as with a sale initiated by the homeowner, REX & Co. and the homeowner will share in the sale proceeds according to their percentage ownership interests.

If, at any time prior to REX & Co.'s exercise of the Option, the homeowner decides to terminate the Option, the homeowner is free to do so by paying REX & Co. the value of REX & Co.'s interest in the home at that time. By doing so, the homeowner is essentially "repurchasing" the Option. (Please note that if the homeowner "repurchases" the Option *in the first five years*, and if the home value has depreciated, the homeowner would have to pay REX & Co. its percentage based on the home's *original* agreed-upon value, not the depreciated current value.)

Finally, if the homeowner proposes to sell the home for a price that REX & Co. considers to be too low, REX & Co. will have the right of first refusal to purchase the home for the sales price proposed by the homeowner. Likewise, if at any time after REX & Co. exercises the Option and becomes a co-owner, REX & Co. proposes to sell the home for a price the homeowner considers to be too low, the homeowner will have the right of first refusal to purchase the home for the sales price proposed by REX & Co. (These provisions are intended to discourage non-arms' length transactions, not to impede the marketability of the property. Achieving the best possible sales price is in the interest of both REX & Co. and the homeowner.)

How Does a REX Agreement Actually Work?

A practical example of how the program actually works may help explain the legal issues involved:

Assume that when the REX Agreement is entered into, the homeowner's home has an agreed-upon value of $750,000, and assume that the homeowner would like to gain access to $100,000 of his or her equity in exchange for *sharing 50% of the future change in value* of the home. REX & Co. would enter into an option agreement to purchase 50% of the home in the future upon exercise of the Option. As part of the option agreement, REX & Co.

would make a $100,000 Advance Payment to the homeowner today, and REX & Co. would receive a 10-year option (renewable at REX & Co.'s discretion for up to 40 additional years -- 30 years in Illinois and 20 years in North Carolina) to purchase 50% of the home. If the Option is exercised six years or more after it has been given, REX & Co. will have to pay the homeowner an additional $275,000 to exercise its Option, which would be the balance of the Option Exercise Price. (The total payment would equal $375,000, including the $100,000 Advance Payment. Note, as discussed above, that if within the first five years the homeowner sells the home, or REX & Co. exercises its option, the additional payment (and thus, the total Option Exercise Price) would be less. In this example, if the homeowner should decide to sell the home early, within five years of the grant of the Option, the additional payment paid upon exercise of the Option in the first year would be $250,000 (i.e., $275,000 less 25% of the $100,000 Advance Payment in the first year), increasing to $270,000 by the fifth year, and thereafter $275,000, all as stated in the executed option agreement.)

For granting the option to REX & Co., the homeowner will also receive an Option Fee of 0.5% of the Option Exercise Price ($1,875), and a flat Covenant Fee of $1,000. These fees paid to the homeowner at origination should roughly equal the title insurance, appraisal, and closing costs for completing the transaction. [2] The same Option Fees and Covenant Fees are paid every 10 years, if REX & Co. decides to renew its Option for another 10-year period. As noted above, the transaction has been structured as an option contact, and thus the amounts received for the Option (the $100,000 and the $1,875) should not be taxable until the option transaction closes (typically, when the home is sold).

If the homeowner in this example sells his or her home six years later for $900,000 (a 20% increase in value), $750,000 (unchanged value), or $600,000 (a 20% decrease in value), the resulting payments are as follows:

AFTER 6 YEARS HOME VALUE HAS INCREASED 20% TO $900,000

	Homeowner receives	**REX receives**
Sale proceeds	$450,000*(50%)*	$450,000*(50%)*
Additional payment (remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$725,000**	**$175,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$825,000**	**$75,000**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

AFTER 6 YEARS HOME VALUE IS UNCHANGED AT $750,000

	Homeowner receives	**REX receives**
Sale proceeds	$375,000*(50%)*	$375,000*(50%)*
Additional payment(remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$650,000**	**$100,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$750,000**	**$0**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

AFTER 6 YEARS HOME VALUE HAS DECREASED 20% TO $600,000

	Homeowner receives	**REX receives**
Sale proceeds	$300,000*(50%)*	$300,000*(50%)*
Additional payment(remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$575,000**	**$25,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$675,000**	**$-75,000**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

Of course, since REX & Co. is receiving a percentage of the home's value, any gain made by REX & Co. on the sale has the effect of reducing the homeowner's gain on his or her property. And, assuming the option tax treatment noted above, after the sale the homeowner would recognize his or her gain based on his or her original cost basis and net proceeds from the sale. Of course, depending on the homeowner's basis and marital status, any gain up to $500,000 may be exempt from taxation and, even if taxable, should be taxable at the capital gains tax rate.

What are the Homeowner's Obligations?

The homeowner's obligations are specified in the covenant agreement. That agreement has a number of detailed provisions that a homeowner and his or her attorney will need to review carefully. However, the principal homeowner obligations are as follows:

1. The homeowner will be obligated to take the following actions in order to protect REX & Co.'s rights in the home and its value:
    a. to live in the home as his or her principal residence;
    b. to maintain the property in good condition (ordinary wear and tear excepted);
    c. to maintain replacement-value property insurance;
    d. to pay all property taxes and assessments;
    e. to pay all loans promptly and not incur any unauthorized liens; and
    f. to avoid incurring loans that exceed the "Maximum Authorized Debt" (usually 70%-80% of the original agreed-upon value) or that have a risk of doing so (such as negative amortizing loans). (As noted above, REX & Co. contractually agrees to subordinate to loans or refinancings that will not do so.)

       The covenant agreement specifically provides the homeowner a 30-day cure period following REX & Co.'s notification of the homeowner of the homeowner's failure to comply with these requirements.
2. The homeowner also has a number of miscellaneous obligations, such as notifying REX & Co. when he or she plans to sell the home and allowing inspections of the property upon reasonable notice.

When Can REX & Co. Exercise its Option or its Other Rights in the Home?

1. If the homeowner proposes to sell or otherwise dispose of the home:
    a. REX & Co. can exercise its Option and be paid its percentage of ownership, and
    b. REX & Co. also has a 3-business-day right of first refusal to purchase the home at the agreed-upon sales price, in order to avoid sales at an unreasonably low price.
2. If the homeowner fails to protect REX & Co.'s rights in the home or its value (as discussed above), REX & Co. can exercise its Option.
3. Upon the expiration of the Option period (as noted above, this is generally 50 years, but it may be a shorter period of time in some states).
4. If the homeowner, a court, or a bankruptcy trustee blocks REX & Co's exercise of the Option, REX & Co. can enforce its security interest over the entire home.

The Purpose of the Recorded Documents

As noted above, in addition to executing the covenant agreement and option agreement, the homeowner executes (a) a recorded memorandum which reflects the existence of the Option, the covenants that run with the land and a limited power of attorney, and (b) a recorded security instrument. Both documents are recorded in the real property records of the county in which the property is located.

Simply put, the recorded memorandum (i) provides assurance that no later lienholders or buyers will take an interest in the home without notice of REX & Co.'s rights in the home and of the obligations of whoever acquires title to the home, and allows REX & Co. to obtain title insurance, and (ii) includes a limited power of attorney which allows REX & Co., upon becoming a co-owner of the home, to sell the entire home, and then split the proceeds with the homeowner. The security instrument is designed for the unlikely event that the homeowner declares bankruptcy and the trustee in bankruptcy rejects the option contract. It allows REX & Co. to assert a secured claim in the homeowner's bankruptcy with a lien against the home and in that bankruptcy case to receive the same percentage of the home's value that the homeowner had agreed to, as if there had been no bankruptcy and REX & Co. had been permitted to exercise its Option.

For the Homeowner: Safety and Diversification

The REX Agreement has been designed to allow the homeowner to stay in his or her home for up to 50 years and to retain substantially all benefits of home ownership, while being able to diversify part of the home's value and risks. Currently, the median United States homeowner holds 70% to 80% of his or her net worth in their principal residence's equity, [3] and many financial advisers suggest that holding too much of one's net worth in any asset, no matter how apparently conservative, is not wise. [4] In fact, some business writers go further. Most notably, David Crook wrote an article in *The Wall Street Journal* on March 12, 2007 entitled: "Why Your Home Isn't the Investment You Think It Is: Too many people rely on their home as their primary savings strategy. That's a mistake." In that article, Mr. Crook states that "houses are not very good investments" and that "[a] house is an inefficient way of building wealth."

It is essential for practicing lawyers to review and to advise their clients on the economics of a transaction, as well as its legal documentation and implications. Part of that review for a REX Agreement may include the purposes for which the Advance Payment is to be used. These purposes may be anything the homeowner wishes, but will hopefully be for significant reasons, including: diversification of asset class ownership; lowering home debt and concomitant lowering of a related mortgage and mortgage payments; use in connection with the purchase of a new home or as a down payment for a second or retirement home; purchase of long term care insurance or an annuity; payment of college tuition for children or grandchildren or setting up 529 plans; or making a major charitable donation or charitable annuity donation. The reasons for using a REX Agreement are only limited by imagination. However, the ability to unlock home equity without the incurrence of debt is an idea that has been long overdue.

Mr. Abbott is Chief Legal Officer and Director of Government Affairs at The REX Group and also serves as an Of Counsel to Howard, Rice, Nemerovski, Canady, Falk & Rabkin, P.C., both of which are located in San Francisco, California.

Mr. Muñoz is a Partner at Reed Smith LLP in San Francisco, California and serves as an outside counsel to REX & Co.

---

[1] See *The Wall Street Journal*, May 8, 2007, at D3. REX Agreements are a proprietary product of Real Estate Equity Exchange, Inc., dba REX & Co., a Delaware corporation located in San Francisco.
[2] In addition to the title insurance costs, a full appraisal from an independent third-party appraiser typically costs between $500 and $1,000, and there are usually some fees paid for notaries, wire transfers, document recording, and similar items.
[3] *Net Worth and Asset Ownership of Households: 1998 and 2000*, U.S. Census Bureau.
[4] See, e.g., Professor Harry Markowitz, "Portfolio Selection”, *The Journal of Finance*, Vol. VII, No. 1, March 1952.

Back to Top

< /