The Consumer Finance Podcast x _Payments Pros_ Podcast – Point-of-Sale Finance Series: Unpacking Leases and RTO Models
Host: Chris Willis
Guests: Jason Cover and Taylor Gess
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Chris Willis:

Welcome to _The Consumer Finance Podcast_. I'm Chris Willis, the Co-Leader of Troutman Pepper Locke's Consumer Financial Services Regulatory Practice. Today's episode is another in our continuing series about point-of-sale finance, in which we're going to be talking about leases and rent-to-own models.

But before we jump into that topic, let me remind you to visit and subscribe to our blogs, TroutmanFinancialServices.com and ConsumerFinancialServicesLawMonitor.com. And don't forget about all of our other podcasts, the _FCRA Focus_, _The Crypto Exchange_, _Unauthorized Access_, which is our data security and privacy podcast, _Payments Pros_, and of course, _Moving the Metal_. Those are available on all popular podcast platforms. Speaking of those platforms, if you like this podcast, let us know. Leave us a review on your podcast platform of choice and let us know how we're doing.

Now, as I said today, we're going to be registering yet another in our continuing series of point-of-sale finance, and we're going to be talking about leases and rent-to-own. Joining me for this episode are my colleagues, Jason Cover and Taylor Gess. Taylor, Jason, thanks again for being on.

Jason Cover:

Thanks, Chris. Good to be back.

Taylor Gess:

Yes, thanks for having us.

Chris Willis:

I have to say, though, it's a little confusing because we're three episodes in to our series on point-of-sale finance and we're talking about leases. Why are we talking about leases and rent-to-own in the context of point-of-sale finance, Jason?

Jason Cover:

Yes, I guess that's right, Chris. But if you think about it, leases have long been a way for an option for customers at the point of sale to obtain goods or services even if it's temporary. And we're seeing clients increasingly use various leasing or lease adjacent products in creative ways both to take a product home today and potentially own it in the future. And not for nothing, if you think about it, there's always that, most people, I think, are familiar with leasing a car. And at the end of every car lease, there is that option to buy outright at the end. So, maybe this is quasi-finance, but it's tangentially related and I think a really pertinent way that we're seeing clients work themselves into that kind of point-of-sale transaction.

Chris Willis:

Yes, honestly, I mean, just from the standpoint of observing the industry, this is a product that I feel like has become really increasingly popular over the last few years. So, I actually agree that it's very important for us to cover on today's episode.

Jason Cover:

Absolutely.

Chris Willis:

So, Taylor, let me just switch over to you. Why don't you start with the basics and tell the audience a little bit about leasing or rent-to-own as sort of point-of-sale type options for consumers?

Taylor Gess:

Sure, Chris. So, I think when most people think about leasing, kind of how Jason hinted at earlier, they think about leasing a car, just because that's what's most familiar in most people's day-to-day lives. And there is a federal statute that governs those traditional lease products, the Consumer Leasing Act, and it's implementing regulation, Regulation M. And under that law, a consumer lease is a contract in the form of a bailment or a lease for the use of personal property by a natural person, primarily for personal family or household purposes, importantly here for a period exceeding four months. That's whether or not the lessee has the option to purchase or otherwise become the owner of the property when the lease is over.

To be a consumer lease under Reg M, we need to have a lease-to-use property for consumer purposes for at least four months. In a consumer lease, the consumer may, but does not need to, have the option to purchase at the end of the lease. And the consumer obtains the legal right to the goods leased only after they successfully complete the terms of the contract that requires to obtain that ownership of the property.

Jason Cover:

Chris and Taylor, just to point out quickly here from what Taylor said, we already noted that a lease doesn't necessarily preclude the purchase of the goods. I want to also point out that four-month time frame, so the lease under Reg M, the triggering Reg M, has to be four months. We'll talk about that in a second, but it's an important anecdote.

Chris Willis:

Well, and there's actually sort of a similar trigger in Dodd-Frank about what constitutes a consumer financial product or service. And as I recall, there's a minimum of a three-month duration for the initial term of a lease to trigger that as being part of the CFPB's jurisdiction under Dodd-Frank. But Taylor was talking about the way that rent-to-own works and where the consumer may have a purchase option at the end of a lease or in a rent-to-own situation that the consumer would obtain title to the goods after completing the terms of the rental purchase agreement. Aren't there issues under Reg Z with the purchase option?

Jason Cover:

That's right, Chris. I guess there's two primary federal disclosure statutes. There's CLA and Reg M, as Taylor mentioned, and probably everyone listening to this podcast knows there's TILA and Regulation Z, which governs credit. And shockingly enough, the credit sales and leases, once they get close enough together, have shared characteristics. And a common attack on leases is recharacterization as Reg Z or recharacterization under state credit statutes.

So, I think Taylor sort of mentioned what the definition of consumer leases under Reg M, but that credit sale definition is equally as important. So again, it's kind of broken into three phases here, and you need all of them for it to trigger. Again, that bailment or lease concept, who knows what a bailment means, but we know what a lease means at least. The triggers here are somebody must agree to pay as compensation for use of some substantially equivalent to or in excess of the total value of property. Strike one, we've paid more over the term of the lease than it was to purchase the goods outright and then has the option to become for no additional consideration or phenomenal consideration to owner. So, it's sort of like, you pay more and then take it home with you. Everything's done and you don't do anything else.

Going back to that car lease example, no car lease gives you the car outright. You always have to pay something additional that's material after the fact. So, that's how like a car lease would break this up. And then the third trigger that's really important is to be a credit sale, the contract can't be terminal. You have to be on the hook for the whole thing. So, if the contract is terminable without penalty, it again breaks that chain of what a credit sale is. That's a really important component to some of the new products we were talking, neither new, not new necessarily, but spins on traditional products like RTO that we're going to talk about here.

Chris Willis:

Got it. Now, that we've sort of set the table from a legal standpoint, Taylor, do you mind sort of going through the types of permutations of products that companies in the market have constructed under the legal framework that we've just been talking about?

Taylor Gess:

Sure, Chris. So, I think first we have that traditional Reg M lease. And when we think about that kind of how we've already touched on the first product that comes to mind are auto leases. And we also see these in the solar industry, leases for solar panels. So, we're going to get into the details on both those industries in later podcasts. I'm going to hold off on any further details for now.

Jason Cover:

I'm sorry. Just real quick, like, a pertinent point here, I think is that most people's experience is that Reg M lease for a car, and it doesn't have to be that way, right? There's other goods and services, I keep saying services, but goods you can lease and solar panels are a good demonstration of that. There's another use case for a longer-term lease product like a car lease, and we're seeing clients kind of incorporate that in. So, I think just as an initial matter, people shouldn't have their blinders on that lease means for a car, there's other things that one could lease.

Taylor Gess:

Yes, Jason, that makes sense. Then, so we also have rent-to-own or RTO, and I think this can get a bit confusing for people here with the difference between a lease and a rent-to-own transaction is. So, rent-to-own transactions, these are frequently going to involve goods like appliances, furniture, computers, other electronics like gaming systems. And in an RTO transaction, each term is less than that four-month trigger for the CLA and Reg M. The terms are usually monthly, bimonthly, or weekly. And the RTO contract between the retail merchant and the seller is terminable at the end of any given monthly, bimonthly, or weekly term without penalty, and the RTO contract contains a purchase option.

So, I think we can think about an RTO contract as generally short-term renewable transactions that are terminable at will without penalty for the termination where the consumer is obligated to make only one payment for the first term at the time the contract is signed. So, if the consumer wants to continue their use of the good, then they make payment from the next term and the RTO transaction is renewed. And if the consumer makes all the required payments or exercises their purchase option, then the consumer obtains ownership of the property.

Jason Cover:

So, Chris, kind of rewinding back to Reg Z and Reg M, right? Taylor mentioned really important points. These RTO statutes and RTO products are always on less than four-months terms. And by a period, we do mean the individual rental period being two weeks, biweekly, monthly, like Taylor mentioned. It's not measured over a two-year course of repeated terms. It is that individual term that's measured under Reg Z. And there's plenty of really, really strong case law on that, and then statutory at the state level supports that as well.

So, that kind of four months thing gets you out of Reg M, and then those are measured under the Reg Z, like, is the entire term equal to or greater than the amount of the goods? No, it's you're only paying for that two weeks, again, not the entire term, right? So, that concept is super important. Then the terminable at will, again, that breaks that chain of what a credit sale is under Reg Z. So, all of those are super important points. Then sorry, just one other thing there, I guess we should say this is what we might call, or others in the industry call, traditional RTO and it's usually like store-based with those types of goods that Taylor mentioned. Then somebody comes into a physical store, the stuff is there and rents it from that store as opposed to what Taylor is going to talk about next.

Chris Willis:

Yes. So, Taylor, let's do talk about that because I've always thought about rent-to-own as having sort of a specific brick-and-mortar presence where the store is basically a rent-to-own store, and you go in there for that purpose and that's all that they do. But there's been a significant evolution in these products over the last few years into other areas, too. Do you mind talking to the audience about that?

Taylor Gess:

Sure. So, beyond those traditional brick-and-mortar, traditional RTO spaces, we also are seeing a lot of activity in the virtual RTO space. So, this can look like a couple of different things. Sometimes consumers go to a physical merchant store and there's a kiosk for an RTO transaction. Sometimes it's through a website or a mobile application. But basically, in these virtual RTO models, the general retailer sells the good to the RTO company for the RTO company to rent to the consumer. These are becoming increasingly common.

Jason Cover:

Yes. Chris, to Taylor's point, this is really just an industry that's boomed exponentially, I would say, in the last 5 to 10 years. So, our clients really like this product. Merchants really like the product and are increasingly including it sort of in their point-of-sale option. So, it's really interesting and novel and sort of a cutting-edge type of product that we're seeing live.

Taylor Gess:

Yes. And Chris, the only other thing I want to mention here is that most states do have RTO laws that consider these short-term renewable transactions outside of credit sale laws, how Jason talked about earlier, and these standalone RTO laws typically have disclosure requirements, advertising or hanging requirements, maybe some pricing restrictions. So, those state laws are important to keep in mind.

Chris Willis:

Yes, absolutely. Whenever I think of those state RTO laws, I think of California's Carnet Act as sort of the prototype of those and one that has many more restrictions than certain other state laws. So, that's I think, one for people to be aware of. And Jason, beyond the sort of rent-to-own, both classical and virtual, are there any other variations of this product on the market that we should talk to the audience about?

Jason Cover:

Yes. I think we've seen clients come up with even more novel products than this. So, again, outside the context of a Reg M lease, outside the context of RTO, you can still build a viable product. One use case we've seen is for ride-share programs where maybe somebody just wants to rent a car for two weeks or something to participate in a ride-share program. That's again, it's not covered by Reg M because it's for a term of less than four months. In that context, there isn't this concept of taking the product home at the end of the day and owning it. It's really, truly just a short-term lease in the same way they're going to a rental car company is in some fashion.

So, there's a bunch of interesting permutations around there once you start playing around with those triggers in the various laws we've been discussing.

Chris Willis:

Yes, it makes sense. But I think as our discussion has illustrated, it's very easy to structure one of these programs in a way that inadvertently subjects you to a regulatory scheme you didn't think you were subject to, which isn't a fun thing for anybody. So, I'd love, Jason, for you to sort of round us out by talking about some of the risks associated with leasing and rent-to-own type products that people need to consider when they're setting one up or administering one.

Jason Cover:

Sure. Absolutely. We kind of talked about this before, but one of the biggest risks with these programs is re-characterization, either under federal or state law. And by re-characterization, I mean, someone will assert this isn't a true lease or it's not a true RTO product and is instead some sort of credit sale or credit product. So, this is always kind of an inherent risk once we get into financing a product with a lease and you take ownership at the end of the day. So, you really need to think about that.

The nice thing about the RTO statutes is they generally do carve out if you sort of dot your I's and cross your T's that it's not credit under state law if you satisfy the RTO statute requirements as you noted, Chris. So, that's a good start, but you need to think about how your program works to avoid these types of claims as well.

Relatedly documenting the transaction. So, in the world that Taylor talked about, virtual RTO, make sure that if you contract with a merchant, you're talking about how you purchase the thing from the merchant and then lease it to the consumer. This is sort of like what we talked about on the credit sale podcast with making sure you document the transaction as a credit sale. Equally, we need to make sure that we're talking about it as a lease here. And then kind of related to that, making sure that customers understand what the transaction is. I think that's been one of the criticisms that you see from this industry is that folks don't understand, wrongfully or rightly, that's the claim. They don't understand that this was the lease. They thought they were buying the thing outright. They thought they were buying it on credit, yada, yada, yada. So, making sure that your customer-facing disclosures, your customer-facing marketing, all of that is really, really strong in terms of saying, “Hey, this is a lease.”

Avoiding things like mentioning loans or financing, like we talked about the opening of the conversation here, so that it's crystal clear what's going on, and it's crystal clear that the customer understands that they won't own the product until, they satisfy all the terms of the lease. Kind of on that same vein, I think one of the reasons cars have always been the main product, kind of that focus here, is because they have residual value, right, and a market to buy the car. So, it's very easy to peg a price at the end of that lease to say, “Hey, here's what you buy this car for.” That's something to also consider when you're thinking about this is like, “Okay, I'm going to lease this product. Do I know what the value is at the end of the lease? And how do I peg the transition from being a lease product to an owned property in that sense?”

Chris Willis:

Yes, all that makes sense. And I really appreciate that from you, Jason, in terms of some of the potential trouble spots that clients need to watch for. And Taylor, for your explanation of the legal backdrop and the operational details of these as well. So, thank you both for being on the podcast again today. And of course, thanks to our audience for listening as well.

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