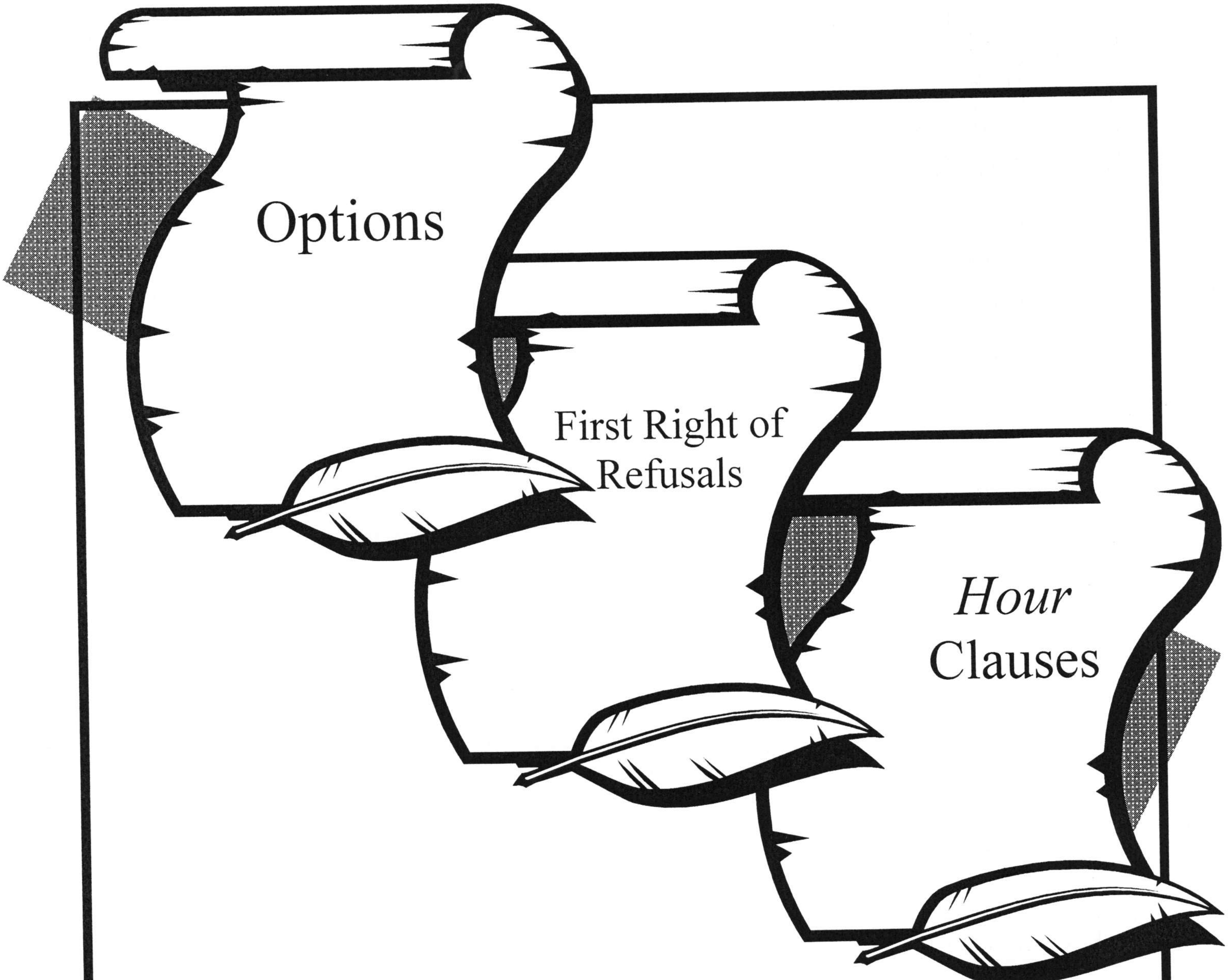

Options, First Right of Refusals and Hour Clauses

Approved: Iowa Real Estate Commission

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This course should not be used as a substitute for competent legal advice.
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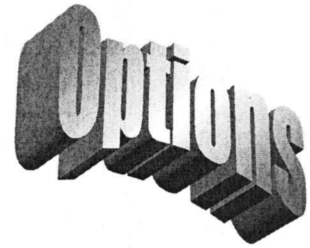
Chapter #1: Options



Options to Purchase Real Property

Overview: An option is very similar to a sales contract but with differences in contract enforcement and purpose. As indicated by its name, the option allows a purchaser to pursue different and various courses of actions.

As a result of studying this chapter, you should be able to:

- Define an option.
- Recite basic characteristics of an option.
- Differentiate between an option and a sales contract.
- State who signs an option.
- Describe "puts" and "calls."

Question #1: What is an option?
Answer: "An option to purchase real property may be defined as a contract by which an owner of real property agrees with another person that the latter shall have the privilege of buying the property at a specified price within a specified time, or within a reasonable time in the future, and which imposes no obligation to purchase upon the person to whom it is given. Until the holder or owner of an option for the purchase of property exercises it, he has nothing but a mere right to acquire an interest, and has neither the ownership of nor any interest in the property itself." 77 American Jurisprudence 2d 27

Question #2: What do you call the owner of the land who is selling an option?
Answer: The owner of the property selling the land is called the optionor.

Question#3: What do you call the prospective buyer of the land who is buying the option?
Answer: The prospective purchaser of the land or property is the optionee.
Here is a rule to help you learn how to remember all the words that end in "ee" or "or." Words ending in "or." Remember the "r" in "or". This is the person in the transaction receiving the money. The word "receive" starts with letter "r".

The words ending with "ee" indicate the person exiting the money. The word "exit" starts with letter "e."

Let's review some of the key words to help review the rule. Mortgagor: the borrower, the person receiving the money at the time of closing from the lender. Mortgagee: the lender, the person exiting the money at the closing. Vendor: the seller, the person receiving the money from the buyer. Vendee: the purchaser, the person exiting the money at the time of the closing. You can do the same for lessor and lessee, grantor and grantee and others.

Question #4: May the owner of the land withdraw his offer to sell during the option time period?
Answer: No. The option is a continuing offer by the landowner to sell the property in question to the optionee within the time limited by the option, and at the price stipulated, which may not be withdrawn until the expiration of the time limit.

Question #5 : So what's the fundamental difference between an option and a sales contract?

Answer: The sales contract creates a mutual obligation on the seller to sell and the buyer to buy. The option merely gives the right to purchase within a limited time without imposing any obligation to purchase. "An agreement by which a party is bound absolutely to purchase land is not an option but an agreement of purchase and sale." McGuire vs. Andre 65 So 2d 185

Question #6: Does an option describe a price or a rent amount?
Answer: Yes. The option describes a purchase price or a lease amount.

Question #7: Does an option need to be for a certain time period?
Answer: Yes, options should be for certain periods of time. The time period may vary from one day to the entire period of a 20 year farm lease. The time could run parallel to the lease or for a stated period of time before or after the lease. It is important to understand that when any contract or option lacks a specific time period that the contract may be unenforceable in a court of law. It is normally against the law to have an agreement which runs perpetually into the future. In one state the author is aware of, only corporations are legally existing perpetuities. Therefore options need to have a stated deadline or time period for which they are effective.

Question #8: Should an option be in writing?
Answer: Options should be in writing to prevent misunderstandings about the option terms and details. Contracts pertaining to real property should be in writing to be enforceable. The purpose of the Statute of Frauds (the original statute of frauds has it roots in England back in 16__) is to require the parties to the contract to write their agreement; if they do, it becomes enforceable in court. There are exceptions to the Statute of Frauds where verbal agreements may be enforced in court. Exceptions may include the passage of consideration or possession by the potential purchaser with the permission of the owner.

Question #9: Should an option be signed by all parties?
Answer: No; only the optionor-seller should sign the option. The option has the nature of being unilateral as opposed to a regular sales contract which is bilateral (where both parties agree to do or not to do a certain thing). Unilateral documents place obligations on only one party and not all parties. Another example of a unilateral document is the deed used in a real estate transaction whereby the grantor-seller relinquishes all rights to the grantee-buyer.

There is an exception to this rule that only the optionor-seller signs the option. Should the optionor and optionee have an agreement that the optionee will give back to the seller, as an example, the right to have an easement after the purchaser exercises the option, both optionor-seller and optionee-buyer may sign the option. The same could be true of a deed. Should the grantor-seller want to reserve an easement over the property after releasing all ownership interests in the property, the grantee-buyer may sign the deed reserving this easement to the grantor seller.

Question #10: Should an option recite a certain amount of option money or consideration?
Answer: Yes, the option should recite a certain amount of money or consideration.

Normally the optionee-buyer tenders an agreed amount of money called "option money." If the optionee-buyer does not exercise the option, the optionee-buyer loses or forfeits this money to compensate the optionor-seller for removing the property from the market place (even though the seller could continue to market the property subject to the right of the optionee to exercise the option).

Traditionally, the optionee-buyer loses the option money should he/she not exercise the option but this is not always the case. The parties to the option could agree that the optionee-buyer receive a full refund of the option money or even a partial return of the money.

Question #11: Does an option recite a price or rental amount for the property?

Answer: Yes; the option recites a price or rental amount for the property. The price in the option, of course, is different than the option money which may be forfeited should the buyer not exercise the option. The price is locked-in during the negotiations for the option. Should the buyer fail to bring his offer in accordance with the terms stipulated in the option, the purchaser may have his attempt to exercise the option disregarded.

Question #12: What are puts and calls?
Answer: "Calls" are more easily described than "puts." A call is an option and has the same characteristics as an option. "Puts" are different and are most applicable to the stock market. It is possible to purchase a put on a stock. When the stock goes down in value, the holder of the put makes money on the way down. Should you purchase a put on a stock which is currently trading for $50 and it drops in value to $30, you make $20 for each stock you negotiated the put, minus the cost of the put. The put is very similar to buying insurance to cover a loss. If the stock in our example went up to $60 a share, the holder of the put would be responsible to pay from their own pocket the amount the stock went up, or $10. With a stock option, you make money on the way up (minus the cost of the option); with puts you make money on the way down (minus the cost of the put).

Question #13: Can the owner of the land be forced to sell the land by the owner of the option?
Answer: Yes, but only for the price and terms of the option. Therefore, two (2) things are important for the enforcement of the option: price and terms. Should the optionee-buyer try to force the optionor-seller to transfer the property at terms not agreed upon, the optionor-seller may refuse to consummate the transaction.

The optionee-buyer can force the seller to sell at the price stated in the option. This is true even though the value of the property has risen thereby creating potential profit for the optionee-buyer. If the property should lower in value, the optionee-buyer may refuse to exercise the option but only loses the money tendered to obtain the option.

There are at least three exceptions when the optionor-seller may *not* be forced to sell the property to the holder of the option (optionee-buyer is the holder of the option).

Exception #1: Chapter 7 Bankruptcy. The optionor-seller may possibly enter Chapter 7 Bankruptcy and discharge the optionee-buyer. Once discharged, the optionee-buyer would lose rights to enforce her option. Chapter 7 is the liquidation chapter of bankruptcy and has the advantage to the debtor to obtain a "fresh start" after discharging creditors. Chapters 11 & 13 are the re-organization chapters and give the advantage of temporary relief from creditors while trying to "turn-the-corner" in the market place. Should this temporary relief from creditors not be sufficient, the debtor may convert to Chapter 7 and totally discharge the creditor. The optionor-seller may use this strategy to get out from under the option agreement.

Exception #2. Another exception would include homestead protection. The owner of a parcel of land may shield only one property from execution (sheriff's sale to satisfy a judgment). The seller refuses to sell; the purchaser sues for specific performance; the seller may use his homestead for protection in this situation.

Exception #3. Eminent domain. Eminent domain is the right or authority of the government to take private property for public use with the return of just compensation. Should the government (city, county, state or federal) take the property which is the object of an option, the owner of the land receives just compensation and the holder of the option receives nothing. Courts have repeatedly said that the holder of an option has no real property interest in the property.

Question #14: Can the seller force the buyer to exercise the option?
Answer: No. This is the beauty of an option. The optionee-buyer may force the seller but the optionor-seller cannot force the buyer to purchase the property.

Question #15: Why would a person rather have an option to purchase a property rather than an enforceable sales contract to purchase the property?
Answer: When a person contemplates the purchase of a property several questions may need to be answered: Will I be able to secure financing? Will I be able to use the property for a certain purpose? Will I be able to obtain insurance on the property at a reasonable rate? Will the property be able to generate adequate revenue at this location?

Herein lies the difference between pursuing a sales contract and an option. If the above items are placed in a sales contract as contingencies, the purchaser must act in good faith on these contingencies. If the purchaser does not, the seller may sue for damages or specific performance or purchase price. You would agree that the seller has a firm grip on the purchaser because of the sales contract. If the buyer does not try with diligence to fulfill the contingency or does not try for the entire time period to fulfill the contingency, the court will construe that as bad faith and may force the buyer to purchase the seller's property irregardless of the contingency.

The option is different. The buyer may be faced with the same questions mentioned above, but the buyer does not need to act in good faith to any extent under the option. Whether or not the buyer acts under the option is the true nature and character of the option and the optionor-seller lacks ability to enforce the option against the optionee-buyer.

Question #16: What are practical situations and reasons for using an option?
Answer #1: Marketing reasons. The landlord may be able to rent the property sooner by giving a tenant a lease with an option to purchase the property.
Answer #2: Maintenance reasons. The landlord may give the tenant a lease with an option to purchase to motivate the tenant to keep the property in better condition. The tenant "sleeps in the bed he has made" when he exercises the option and has either kept the property in good or poor condition. Consequently, the option gives incentive to the tenant to keep the property in good shape.
Answer #3: Reciprocating courtesies. "I will give to you an option to purchase my home if you will give me an option to purchase your home." Two farmers may own properties closer to each other than to themselves. To create more efficiencies in their operations, they exchange options to purchase the other's property.
Answer #4: Negotiating reasons. The buyer really wants the seller's property and has wanted it for many years. The buyer is well known for his wealth and fears the seller may inflate the price detecting the buyer's eagerness to own the property. To camouflage his eagerness, the buyer may negotiate an option to purchase rather than a sales contract.
Answer #5: If the taxpayer is seeking property to complete a 1031 tax-deferred exchange, the taxpayer may benefit from a "reverse Starker" type of exchange. In the normal exchange, the taxpayer transfers their property to an intermediary or a "safe-harbor." This starts a 45 day time period to designate a replacement property and a 180 day time period to close the transaction, according to IRS statutes. The 45 day time period may be troublesome because of its shortness. A reverse Starker exchange has as its strategy to locate the replacement property before the transfer to the intermediary. When the taxpayer locates the replacement property, the taxpayer may use an option to "lock-up" the property to enable the taxpayer to structure the exchange. The option can help the taxpayer avoid the anxiety associated with the rush of finding a replacement property during the 45 day designation period.
Answer #6: An option may help motivate a seller who really doesn't want to sell. "But, if you sell your property to me, I will give to you an option to re-purchase it back to me in the next 5 years for the selling price." As remarkable as this sounds, the author is knowledgeable of situations where this has taken place.

Chapter #2: Options (continued)

Overview

This chapter continues the study of options reviewing legitimate and wrongful uses of this contract. Along with the enforcement of options, other issues are examined.

As a result of studying this chapter, you should be able to:

- Recite two (2) examples of wrongful uses of an option.
- State the event which produces a commission for one obtaining an option.
- Recall limitations on the enforcement of options.
- State what issues should be covered in an option.
- Identify a way to include important issues in the option negotiations.
- State whether an option contract is assignable.

Question #17: What may be an example of a wrongful use of an option?
Answer #1: To interpret a listing as an option would be a wrong use of a listing and an option. When the agent/broker/salesperson negotiates a listing, these persons should not view the listing as an option giving them the right to purchase the property for themselves.
Answer #2: Another example of a wrong use of an option may be between relatives desiring to exchange properties under 26 United States Tax Code 1031. This statute prohibits relatives who have exchanged like-kind property from transferring the property before a 2 year waiting period. This 2 year waiting period applies to the taxpayer and the relative; if either party transfers before the 2 year period has expired, the exchange is disqualified and the taxpayer may not be able to defer the tax. Relatives include persons related through blood, marriage, adoption and business entities. The IRS has discovered that relatives have attempted to circumvent the 2 year waiting period by using a "short sale." By its nature, a short sale is an option. Should either party try to dispose of the property they acquired in the exchange by buying/selling an option to this property before the 2 years has expired, the exchange is disallowed.

Question #18: When does the agent earn a commission when producing a purchaser only willing to purchase an option?
Answer: The agent normally earns a commission when the purchaser becomes ready, willing and able. The optionee-buyer is obtaining an option to make determinations about financing or zoning. In other words, the buyer is ready and willing but not able until the financing is secured. Or, the buyer is able to buy because financing is pre-arranged but not willing and able because the zoning has not been changed to allow for the use desired by the purchaser. When all issues have been resolved the optionee-buyer is now ready, willing and able. This is when the optionee-buyer exercises the option; this is when the agent has earned the commission. But there is an exception to the answer, a very rare exception. The broker may have a listing which allows the agent to earn a commission when finding a buyer who is willing to purchase an option. If that is the case, the purchaser does not need to become ready, willing and able to earn the agent a commission.

Question #19: The owner of the land dies. May the option be enforced against the heirs, devisees, and representatives of a deceased optionor?
Answer: Yes. "...his death before the expiration of the time for exercising the option does not in any

way affect the right of the other party thereafter to make his election and do the things necessary on his part to entitle him to a conveyance." Mueller vs. Nortmann, 93 NW 538

Question # 20: The optionor-seller sells to a third party who knows the seller is obligated under an option. May the optionee-buyer enforce the option against the new owner?
Answer: Yes

Question #21: (Same question as above, but the third party has no knowledge of the option, the option is not recorded at the court house, and the optionee-buyer is not a renter in physical possession of the property. The third party is an innocent purchaser for value.)
Answer: No, but the optionee-buyer may have recourse against the optionor-seller for violating the option. Recourse will include liquidated damages rather than rescission of the sales contract and re-sale to the optionee-buyer.

Question #22: Will the optionee-buyer be required to exercise the option within the time limits imposed by the option?
Answer: Yes. "It is universally held, not only at law but also in equity, that the time named for the exercise of an option is to be regarded as of the essence of the option, whether so expressly stated or not. Unless an option is exercised within the time limited, the rights of the optionee expire without notice or declaration of forfeiture." 77 AmJur 2d 42

Question #23: Are there any exceptions to the rule that the optionee-buyer must exercise the option in a timely fashion?
Answer: Yes. "It is a general rule that an optionor who has given the right to purchase property within a specified time may not do any act or omit to perform any duty calculated to cause the optionee to delay in exercising the right." 77 AmJur 2d 42
Example #1: In Unatin 7-Up Co. vs. Solomon, 350 Pa632, 157 ALR 1304, where an option to buy the plant and equipment of a bottling works expired on a Thursday and the optionee was ready and willing to close the deal the previous afternoon but was informed by the brother of the optionor, who was in charge of the plant, that she was at home because of impending religious holidays which began at sundown and continued over the next Friday, during which she would transact no secular business, and at his suggestion the optionee telephoned to her attorney, who was of the same religious faith, and was instructed by him to return on the following Monday, when he "would have the optionor there and give the optionee a clear title..." and the optionee then again appeared, ready to close the deal, but was refused, the court held, upon the principle that the optionor cannot by his own conduct prevent the optionee from exercising his option within the specified time and later object on that ground, that the optionee had done all in his power and duty to reach the optionor and make timely exercise of the option, even granting that ordinarily the residence of such a party is the proper place to try to do so, in the absence of other stipulation, and was excused from further attempts to do so until the following Monday.

Example #2 Schaeffer vs. Coldren 85 A 98 An optionor cannot mislead an optionee by agreeing to a modification of the terms of payment, and then at the last moment, when it is too late to make other arrangements, refuse to accept the terms agreed upon, and thus defeat the right to exercise the option.

Question #24: An option should speak of what topics and issues?
Answer: An option should speak of all the topics and issues written in a standard purchase agreement, either for the sale of residential, commercial, or industrial property. Those topics include:

- Duration

fixed period and thereafter until notice of termination
fixed period with revocable offer to continue thereafter until notice.

- Evidence of Title—Abstract
- Forfeiture of Consideration for Option
- Manner of exercising option—by payment of purchase price and taxes
- Prohibition against recordation
- Prohibition against sale or encumbrance by optionor
    with provision for damages
    with provision for discharge of encumbrance
        "I further agree neither to sell nor encumber said real estate during said term, and should I encumber said real estate I will discharge such encumbrance immediately on receiving the purchase price."
- Purchase price for land
    Compensation to optionor in event condemnation proceedings become necessary
    The consideration paid for this option is not a part of the purchase price.
    Consideration for option to be credited on purchase price.
        "In event that the holder or holders of this option shall decide to purchase said property at the above price and terms within said time, then and in that case, said amount paid for this option shall be credited on said purchase price, but in the event the holder or holders hereof do not conclude the purchase above named within the time prescribed, then and in that case, said amount paid for this option shall be retained by the undersigned in full satisfaction for holding the property subject to said order for the said time."
    Proceeds from mineral and timber to be credited on purchase price.

- Representation that optionor is owner

"The optionor hereby represents that he is the owner in fee simple of the premises and has full power to give and grant this option."

- Right of optionee to cancel option—on failure of optionor to perfect title

- Right of optionee to enter land

- Right of optionor to growing crops

- Waste by seller

- Risk of loss

- Surrender of possession by optionor

- Terms for consummation of sale—cash sale
    deed subject to existing mortgage
    deed and purchase money mortgage
    sale on land contract
- Time allowed for preparation of abstract

- Time to repurchase land
    Time shall be of the essence of this option and agreement and unless exercised within ______

days this option shall be void.

- Conditioned on zoning for industrial use

Question #25: What is a practical method to include the above items in an option?
Answer: The practical method for including the above items in an option is for the option to make provision for the sales contract that the buyer and seller will ultimately sign once the optionee-buyer decides to exercise the option. This sales contract could be filled out with all the terms and agreements (price, closing date, possession date, proration of taxes, etc.) and signed by the seller but NOT signed by the buyer. This contract could be attached to the option as a referenced addendum to the option. When the optionee-buyer decides to exercise the option, the optionee-buyer simply signs this purchase agreement within the time frame required for the exercise of the option.

Question #26: What is a real life example of a sale with an option to repurchase the land?
Answer: As an instructor of real estate and the author of this program, I love finding a contract form or a contract phrase which has been tested at a state supreme court level. Here is a sale plus option to repurchase the property. It comes from Knox vs. Brown, 277 SW 91.

Option to repurchase land (sale plus option)

Know all men by these present: This option agreement entered into this _____ day of _____, 200_, by and between ______ of ________, and _______ and ________, his wife, of _______ witnesseth:That _______ has this day purchased from ________ and _________ all their undivided _______ interest in and to certain lands situated in ________ County, _____, Known as _______, as evidenced by their deed of this date, recorded in volume _____, page _____ Deed Records, _______ County, _______, which deed is hereby referred to for a complete description of said lands and made a part hereof, and all their undivided ______ interest in and to certain livestock on said lands, as evidenced by their bill of sale of this date for said livestock, which bill of sale is referred to for a complete description of said livestock and made a part hereof, recorded in volume _______, page ______, of the Record of Bills of Sale, _______ County.

In addition to the consideration recited in the instruments above referred to for the purchase price of said lands, and livestock, ______ hereby gives and grants to _____ and _____ his wife, the right, privilege and option of the repurchase by them from him or his assigns an undivided _______ interest in and to said property described in said deed and bill of sale within a certain limited time, on or before _____, 200_, at the same price at which they have this day sold it. It is expressly agreed that if _____ and ______ or either of them do not exercise the right, privilege and option herein given and granted on or before _________, 200__ then this agreement is null and void and of no further force and effect.

________ covenants and binds himself, his heirs, executors, administrators and assigns to carry out the terms of this option agreement.

In witness whereof, etc. Signature

(adapted from Knox vs. Brown, 277 SW91, holding that the option to repurchase expires at the time stated therein, unless previously exercised.)

Question #27: An optionee-buyer has a the right to purchase the property at a given price. During the time of the option, the value of the property decreases. Does the purchaser have the right to force the seller to sell at this reduced value?
Answer: No, unless the option gives the optionee-buyer this right. See: Anderson vs. Bills, 167 NE 864, holding that this option may be specifically enforced even though the property decreases in value.

Question #28: What form would an optionee-buyer sign when exercising the option?
Answer: I have included such a form below which was tested in: Cameron vs. Scherf 62 NW2d 884. It is best to have your attorney prescribe this form and all other forms.
Exercise of option
To ______, __________
You are hereby notified that pursuant to the contract, a copy of which is annexed hereto and made a part hereof, _____, of ______,hereby signifies his intention to take the land described therein, and herein described as follows: _________
You are further notified that the above named _____ is ready, able and willing to perform the terms of the option to purchase the above described premises contained in the above stated contract at such time and in such manner as may be designated by you, and for that purpose is ready, able and willing to deposit the sum of __________ ($________) Dollars to your credit in such time and place as may be designated by you, and hereby demands a warranty deed of said land.
signature
(adapted from Cameron vs. Scherf 62 NW2d 884)

Question #29: Can options be assigned?
Answer: Unless prohibited by state law or in the option, options are normally assignable. See a sample option assignment below; always check with your lawyer about the validity and appropriateness of any form.

Assignment of option and exercise thereof by assignee
date and place
In consideration of ___, ($____) Dollars and other good and valuable considerations, receipt of which is hereby acknowledged, I hereby sell, transfer and assign the foregoing option to _________, who hereby accepts such assignment and agrees to exercise the said option in accordance with its terms. I also acknowledge receipt of _________ ($____) Dollars, as earnest money. In the event that the title to said property is good according to its terms, said earnest money is to apply towards the purchase price.
Signatures

Question #30: What is a double option?
Answer: A great authority on contract law is Corbin. Listen to how he describes the "double option."

"A very simple case of a double option contract would be one in which A gives to B an option to buy Blackacre for $5,000 in return for the giving by B to A an option to buy Whiteacre for $8,000, acceptance in each case to be by actual payment within thirty days. Corbin 1A page 551
There are employment and agency contracts in which both employer and employee are given the option of termination on certain conditions. Each once has the power to terminate by fulfilling the conditions. Corbin 1a page 553"

Options **General Summary Table** **Questions**	**Answers**	**Additional information**
Other names for this contract? What other names are used for this contract?	Options are traditionally not called by any other names other than "options".	Exceptions to this answer may be "calls" or "short sales."
Price? Rental amount? Is the price /rental amount of the property "locked in" when using an option?	Yes.	
Consideration? Is consideration for the option part of the option contract?	Yes	
Time Period? Does an option include a definite time period?	Yes. If the option is not for a definite period of time, the option could become an unenforceable perpetuity.	
In writing? Does the option need to be in writing to be enforceable in a court of law?	Yes. All real estate contracts should be in writing to be enforceable.	
Recordation? Should the option be recorded?	The buyer may want the option recorded to alert the buyer should the seller try to sell the property in violation of the option.	
Enforcement? How can an option be enforced? Who can enforce the option?	As an option holder, the optionee buyer may enforce the option using court remedies of specific performance or liquidated damages.	
Exceptions? Will courts ever refuse to enforce the option?	The optionor-seller may shield themselves using homestead protection (if available),bankruptcy protection and eminent domain.	
Converting to a sales contract. How is the option converted to a sales contract?	The option is converted to a sales contract when the optionee-buyer "exercises" the option.	
Commission? When does the agent earn a commission if the buyer only purchases an option to purchase the property?	The agent normally earns a commission when the optionee-buyer exercises the option.	