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An Examination of Real Estate Purchase Options

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Abstract

A purchase option gives the optionee the choice whether or not to purchase property at certain terms.

KEYWORDS: purchase, lease, bankruptcy

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I. Introduction: The Nature of Purchase Options

A purchase option gives the optionee[1] the choice of whether or not

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1. The optionee is the one who receives the option, the choice. In a purchase option, the optionee has the choice of whether to buy or not. He is the prospective buyer. Colloquially, the optionee is said to "have an option" or to have "taken an option" on the property. The optionor is the one who grants the option. In a purchase option, the optionor is the prospective seller. As this article considers only purchase

to purchase property at certain terms. This article will focus upon options to purchase real property, examining their applications, their benefits and their limitations to gain an understanding of options in perspective. Then the author will provide suggestions for the productive use of this device while eliminating the wasteful litigation which is produced by the current state of the law.

A purchase option is an offer to enter a particular contract to sell which has been made irrevocable. Two contracts are involved. The first, often referred to as an "option contract,"[2] is a unilateral contract[3] which binds the offeror to hold open the offer to enter the second contract, a contract to sell the land. This type of purchase option should be distinguished from options created by will, testamentary options, which are governed by the law of wills rather than contract law.[4]

Traditional contract rules govern the option contracts.[5] The op-

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options, that is the way in which the parties will be referred to throughout. Note, however, that options may be used in various other ways. In other types of options the labels optionor and optionee may fall on the parties differently. For example, if the option gave the seller the choice of whether the buyer would be required to buy, *i.e.* a sale option, the seller would be the optionee.

2. RESTATEMENT (SECOND) OF CONTRACTS § 25 (1981) comment (a) states:

> "*Option*" A promise which constitutes an option contract may be contained in the offer itself, or it may be made separately in a collateral offer to keep the main offer open. Such promises are commonly called "options." But the word "option" is also often used for any continuing offer, even though revocable, and indeed is sometimes used to refer to any power to make a choice. To avoid ambiguity the phrase 'option contract' is used in this Restatement.

3. State v. New Jersey Zinc Co., 40 N.J. 560, 576, 193 A.2d 244, 252 (1963).

4. A testamentary option is a term in a will which gives the beneficiary the right to purchase certain property at a specified price, or a price to be determined according to a method specified by the will. Testamentary options are used primarily by testators who are trying to equalize shares in their estates. This type of option resembles a right of first refusal because, like a right of first refusal, it does not ripen into an exercisable option until the occurrence of a condition precedent. A purchase option contract may be conditioned upon the death of a party, but a testamentary option is subject to a condition precedent that the testator will die without having revoked the will in which the option appears. The testamentary option is a right given to the beneficiary by the will, not by contract as are the purchases discussed in this article. *See* Annotation, *Option Created By Will To Purchase Real Estate*, 44 A.L.R.2d 1214 (1955); Annotation, *Determination Of Price Under Testamentary Option To Buy Real Estate*, 13 A.L.R.4th 947 (1982); Annotation, *Time In Which Option Created By Will To Purchase Real Estate Is To Be Exercised*, 82 A.L.R.3d 790 (1978).

5. Because of the local nature of real estate contracts, it is imperative that the law of the jurisdiction be carefully examined for local idiosyncracies. *See, e.g.*, 1 FLOR-

tionor must receive consideration to make the option contract binding and the offer to enter the second contract irrevocable.[6] The lack of essential terms would be fatal.[7] However, it need not specify all the details of the purchase contract. Some omissions may be filled in by a court assuming the parties intended to use reasonable terms.[8]

When exercised, an option to purchase real property will ripen into a contract for the purchase of real property. The Statute of Frauds provides that a contract for real property must be in writing and signed by the party to be charged. Some jurisdictions apply this writing requirement to purchase options.[9] However, an option is not technically a contract for an interest in real estate, but a contract to hold open an

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IDA REAL ESTATE TRANSACTIONS, Ch. 6B, Option Contracts.

6. *See* discussion of consideration *infra* in section V.

7. Essential terms would include the price, *see* Annotation, *Requisite Definiteness Of Price To Be Paid In Event Of Exercise Of Option For Purchase of Property*, 2 A.L.R.3d 701 (1965) and Annotation, *Specific Performance Of Contract Or Option As Affected By Unexecuted Provision For Determination Of Price By Arbitrators Or Appraisers*, 167 A.L.R. 727 (1947); the time within which the performance must occur, *see* Annotation, *Validity Of Option To Purchase Realty As Affected By Indefiniteness Of Term Provided For Exercise*, 31 A.L.R.3d 522 (1970); and a description of the land, but a street address has been held sufficient. Park West Village, Inc. v. Avise, 714 P.2d 1137 (Utah 1986).

8. *See, e.g.*, Detwiler v. Capone, 357 Pa. 495, 55 A.2d 380 (1947) (The court determined that, absent any specific terms to the contrary, an option in a lease could be exercised at any time during the term of the lease and that the kind of deed to be used, when and where the payment was to be made, and the purchase money mortgage terms were to be the usual reasonable forms and terms.) *See* Annotation, *Validity Of Option To Purchase Realty As Affected By Indefiniteness Of Term Provided For Exercise*, 31 A.L.R.3d 522 (1970).

9. *See, e.g.*, Montanaro Bros. Builders, Inc. v. Snow, 190 Conn. 481, 460 A.2d 1297 (1983) (holding that Connecticut's Statute of Frauds does apply to options); Foy v. Foy, 484 So. 2d 439 (Ala. 1986) (holding that the failure to express a consideration would violate the Alabama Statute of Frauds). However, the courts seem willing to go to lengths to find the existence of a sufficient writing. *See also,* South Florida Citrus Land Co. v. Walden, 59 Fla. 606, 51 So. 554 (1910) (finding a writing sufficient that described the property "all of the land owned by said [defendant] located west and north of the South fork of the Miami river. . ."); Williams v. Williams, 347 N.W.2d 893 (S.D. 1984) (holding that the presence of the right of first refusal in a prior lease, the reference to it in an unexecuted memorandum of extension of the lease and in the lessor's listing agreement were sufficient); Baker v. Jellibeans, 252 Ga. 458, 314 S.E.2d 872 (1984) (holding that despite an integration clause in the option, the writing requirement could be satisfied by reference to documents involving the sale of other lots as part of the same transactions); Broach v. City of Hamilton, 283 Ark. 496, 677 S.W.2d 851 (1984) (holding the grantee's acceptance and recording of the deed containing the repurchase option satisfied the requirements).

offer to enter a real estate contract. As a result of this distinction, the Statute of Frauds is not applied to purchase options in every state.[10] Violating the Statute of Frauds would prevent the optionee from forcing the sale of the land to him and it might also prevent him from recovering what he paid for the optionee, depending on whether the state's version of the statute makes such contracts void or unenforceable. As illustrated by *Braunger v. Snow*,[11] if the option is void, the optionee would be entitled to the return of the consideration paid for it, but he would not if the option was merely unenforceable because he had received what he paid for even if he had no remedy to enforce it.

If the option is not exercised, no contract of sale exists. When the specified period of the option ends, the unexercised option expires and the optionee no longer has the power to accept the offer. The optionee is not entitled to the return of the consideration paid for an expired option because he has received what he paid for, the option.[12]

If the option is exercised, the offer to sell has been accepted and a contract formed. Subsequently, the terms of that contract of sale determine the rights and remedies of the parties.[13] The language of the option will be the primary source in determining those terms, including exactly what property is being purchased.[14] Ambiguities in the contract create questions to be resolved by traditional rules of interpretation.[15]

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10. W.M., R.W., & T.R. Bowler, a Partnership v. TMG Partnership, 357 N.W.2d 109 (Minn. Ct. App. 1984).

11. 405 N.W.2d 643 (S.D. 1987).

12. Chubb v. J. Harker Chadwick & Co., 93 Fla. 114, 111 So. 538 (1927). (Where the option provided for installment payments and further provided that upon a default in any payment the option would be extinguished and the prior payments retained as consideration for the option, the court held that the optionor was not required to return the payments upon terminating the option.)

13. *See* Annotation, *Tenant's Right To Damages For Landlord's Breach Of Tenant's Option To Purchase*, 17 A.L.R.3d 976 (1968); Annotation, *Option To Purchase Real Property As Affected By Optionor's Receipt Of Offer For, Or Sale Of, Larger Tract Which Includes The Optioned Parcel*, 34 A.L.R.4th 1217 (1984).

14. *See, e.g.*, Robbinson v. Central Properties, Inc., 468 So. 2d 986 (Fla. 1985), where the clear and unambiguous language of the right of first refusal extended only to the sale of a water and sewer system and, therefore, did not include a right of first refusal to acquire the stock in the corporation which owned the water and sewer system. The court pointed out that "[i]n construing contracts, the intention of the parties governs, and the intention will be determined from the language when it is unambiguous."

15. *See, e.g.*, S.B.R.'s Restaurant, Ltd. v. Towey, 515 N.Y.S.2d 573 (1987), where the ambiguity whether the tenant had a right of first refusal for the purchase of the entire building or only for the portion of the building occupied by their restaurant

It is sometimes difficult to distinguish between an option and a contract of sale which is subject to conditions.[16] The determination requires careful examination of the terms. The critical factor is whether the parties intended that the potential buyer be obligated to purchase, producing a contract of sale, or have the choice whether to purchase or not, producing an option. An optionee has a free choice to purchase, or not, because he has not yet accepted the seller's offer to sell.[17] In contrast, if the buyer is obligated to purchase, but may be relieved of that obligation by the failure of a condition, the agreement is a contract of sale, not an option.

An example was provided when the Florida Supreme Court considered a written agreement which began, "Received of R.H. Dougherty the sum of $1000.00 for an option to purchase upon the following terms and conditions. . . ."[18] The agreement provided that the initial deposit was to become part of the purchase money if the purchase was completed, that the deposit would be returned if the seller were unable to produce a merchantable title, and the deposit would be forfeited to the seller if the buyer did not perform. The court concluded it was really a contract of sale and not an option because the buyer was obligated to purchase unless the seller failed to satisfy the title condition. If the buyer failed to purchase as obligated, the buyer would, in effect, be liable for breach, the loss of his deposit being the equivalent of liquidated damages.[19]

In contrast, an agreement which appeared to be a sales contract but provided that "[i]f the present owner does not approve of the terms of this contract, or other terms agreeable to both parties, . . ." was an option to purchase rather than an executed contract of sale.[20] The pre-

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created a question of fact as to the parties intent.

16. *See, e.g.*, Ellis and Abramowitz, *Contracts as Commodities: Issues and Approaches in Regard to Commercial Real Estate "Earnest Money" and "Option" Contracts—A Texas Lawyer's Perspective*, 16 ST. MARY'S L.J. 541, 546-555 (1985) (the authors distinguish the two under Texas law.)

17. Acheson v. Smiths, Inc., 110 Fla. 240, 148 So. 576 (1933).

18. Wolfle v. Daugherty, 103 Fla. 432, 137 So. 717 (1931).

19. Consequently, the court concluded that on the failure of the condition due to title problems, the buyer was entitled to recover the money paid and to an equitable vendee's lien on the land for that amount. If the agreement had been a option, then the prospective vendee would not have been entitled to either the return of his money or an equitable lien for the amount paid because he would have received what he paid for, an option.

20. Pick v. Adams, 98 Fla. 140, 123 So. 547 (1929).

sent owner had the free choice whether to approve, that is, accept or not. He was not obligated to perform. Consequently, the agreement was a purchase option and not a contract of sale.

The parties to a contract of sale may agree to limit the remedies in the event of a breach. Some sales contracts specify that the seller would be limited to liquidated damages, usually the amount of the deposit, and prohibited from obtaining specific performance.[21] Because the buyer has the choice of completing the purchase or losing his deposit, it is very similar to an option and some courts may conclude that it is in fact, if not in appearance, an option.[22] The buyer has, for the price of his deposit, purchased the right to go through with the purchase or not without further liability.[23]

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21. There seem to be two incentives for the use of such contracts. The first is availability. Form contracts of sale are readily available to the parties and to real estate brokers. Mass produced option forms seem to be a comparative rarity. Consequently, the parties may try to modify a readily available form to reflect their agreement rather than drafting an entirely new agreement or searching for a more nearly appropriate form.

The other incentive for the use of these contracts may be found in the law governing mortgages. The seller's property may be subject to a mortgage that contains a due-on-sale clause which allows the mortgagee to accelerate the debt, calling the mortgage debt due immediately. The seller does not want the mortgagee to do this simply because he has given an option on the property. Whether the mortgagee can do so generally depends on the terms of the mortgage, but under the Garn-St.Germain Act, most lenders cannot invoke the due-on-sale clause if the property is leased for less than three years or the lease does not include an option to purchase. *See generally* GARN-ST.GERMAIN DEPOSITORY INSTITUTIONS ACT OF 1982, Pub. L. 97-320, 12 U.S.C.A. § 1701j-3. The exemptions are found at § 341(d) and discussion thereof in NELSON AND WHITMAN, REAL ESTATE FINANCE LAW (2d Ed. 1985).

An optionee under a lease which includes an option is not protected by the act. So rather than give a lease with an option to purchase, the seller may enter into a purchase contract with the lessee which calls for closing within the term of the lease (usually one or two years) on thirty days notice from the buyer. Should the buyer fail to close within the term of the lease, he would simply forfeit his purchase deposit. The efficacy of this method of circumventing the due-on-sale clause is dubious but no reported cases on the issue have been discovered. However, on the issue of concealment of events which might trigger the due-on-sale clause, *see id.*

22. *See* Ellis and Abramowitz, *Contracts as Commodities: Issues and Approaches in Regard to Commercial Real Estate "Earnest Money" and "Option" Contracts—A Texas Lawyer's Perspective*, 16 ST. MARY'S L.J. 541, 546-555 (1985), where the authors conclude that the Texas rule is to treat such purchase contracts as options.

23. It was suggested that the converse, an option to sell, might be an illusory contract in Clone, Inc. v. Orr, 476 So. 2d 1300 (Fla. 5th Dist. Ct. App. 1985), where the court concluded that a contract that limited the buyer's damages to recovery of the

The characterization as a contract of sale rather than an option may affect the rights[24] and remedies[25] available to the parties. The doctrine of equitable conversion which shifts the risks of loss to the buyer under a sales contract is inapplicable to options so the optionee does not get an equitable interest in the land as would the buyer under a sales contract.[26] Because the optionee has no interest in the land, the optionee may not be entitled to compensation in the event it is taken by a governmental body using its eminent domain powers.[27]

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deposit from the breaching seller would be nothing more that an "option to sell." However, the court avoided discussing that possibility by focusing on other language in the default clause, concluding that the parties intended an enforceable contract so the default term could not be read to limit the buyer remedies to return of the deposit.

24. *See e.g.*, if the optionors are joint tenants or tenants by the entirety, entering a contract of sale may be found a sufficient manifestation of intent to sever the unities and, consequently, sever the tenancy into a tenancy in common. It is far less likely that such severance would occur based upon the granting of an option, however, the possibility should be considered by the joint options. *See* Annotation, *Contract of Sale or Granting of Option to Purchase, To Third Party, by Both or All of Joint Tenants or Tenants by Entirety as Severing or Terminating Tenancy*, 39 A.L.R.4th 1068 (1985). As with a contract of sale, an option given by a landowner prior to marriage would not be subject to the subsequent wife's dower interest. Detwiler v. Capone, 357 Pa. 495, 55 A.2d 380 (1947).

25. The characterization could be critical in a state that requires a defaulted installment contract to be judicially foreclosed like a mortgage. *See, e.g.*, Boyd v. Watts, 342 S.E.2d 840 (N.C. 1986).

26. The doctrine of equitable conversion is based on the equitable maxim "equity considers done what ought to be done." In a sales contract, the seller ought to convey, so equity treats the parties as if he had, vesting equitable title in the buyer. An option, however, does not obligate the seller to convey until the buyer exercises the option which he might never do. Whitson Co. v. Bluff Creek Oil Co., 278 S.W.2d 339, 342 (Tex. Civ. App. 1955), *aff'd*, 156 Tex. 139, 293 S.W.2d 488 (1956). *See generally* BOYER, SURVEY OF THE LAW OF PROPERTY 375-380 (3d ed. 1981); CUNNINGHAM, STOEBUCK AND WHITMAN, THE LAW OF PROPERTY, §10.13 (19). *See also* Annotation, *Equitable Conversion Doctrine As Applicable To Option To Purchase Land, In The Event Of Death Of Optionor Or Optionee Before Its Exercise*, 172 A.L.R. 438 (1948).

27. East Bay Mun. Util. Dist. v. Kieffer, 99 Cal. App. 240, 278 P. 476 (1929); Cravero v. Florida State Turnpike Authority, 91 So. 2d 312 (Fla. 1956); Phillips Petroleum Co. v. City of Omaha, 171 Neb. 457, 106 N.W.2d 727 (1960); Haney v. Denny, 135 Ind. App. 317, 193 N.E.2d 648 (1963). *Contra In re* Governor Mifflin Joint School Authority, 401 Pa. 387, 164 A.2d 221 (1960).

Whether the optionee's title, after exercising the option, relates back for certain purposes to the execution of the option presents an interesting question. *See* Shaffer v. Flick, 360 Pa. Super. 192, 520 A.2d 50 (1987); Newport Waterworks v. Sisson, 18 R.I. 411, 28 A. 336 (1893) and Mueller v. Nortmann, 116 Wis. 468, 93 N.W. 538 (1903) which hold it does relate back. *Contra* Sheeby v. Scott, 128 Iowa 551, 104 N.W. 1139

The characterization as an option rather than as a contract of sale may also have effect on rights regarding the money paid. The tax treatment may depend on whether it is part of the purchase price of the property or the consideration for the option.[28] In addition, the question of whether an agreement is a contract for sale or an option may determine whether a commission is due to any real estate broker involved and, if so, when. Unless the brokerage contract provides otherwise,[29] a broker is not entitled to a commission for procuring a person who takes an option on the property unless and until the optionee exercises the option[30] or the optionor prevents the optionee from exercising it.[31]

II. Creating a Purchase Option

The purchase option contract must be created in accord with the requirements of contract formation. Generally, there must be an offer to enter the option contract, an acceptance of that offer and considera-

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(1905); Rockland-Rockport Lime Co. v. Leary, 203 N.Y. 469, 97 N.E. 43 (1911); Smith v. Lowenstein, 50 Ohio 346, 34 N.E. 159 (1923); *In re* Bisbee's Estate, 177 Wis. 77, 187 N.W. 653 (1922). *See also* Annotation, *Right To Damages Or Compensation Upon Condemnation Of Property, Of Holder Of Unexercised Option to Purchase*, 85 A.L.R.2d 588 (1962).

28. *See* SAMANSKY AND SMITH, FEDERAL TAXATION OF REAL ESTATE § 7.01[5]. The rules regarding the treatment of payment for an option may affect when the income is recognized and whether the income from an unexercised option may be capital or ordinary and whether the cost of an unexercised option may be a loss and if so whether capital or ordinary.

29. Ordinarily a broker is entitled to a commission for procuring a potential buyer who is ready, willing and able to purchase the property on the terms listed. A potential buyer who only wants to take an option is not necessarily "willing" to buy according to those terms. St. Petersburg Land & Loan Co. v. Shallcross, 84 Fla. 575, 94 So. 502 (1922); Acheson v. Smiths, Inc., 110 Fla. 240, 148 So. 576 (1933). However, under the terms of the brokerage agreement, the seller may be liable for a commission if the broker provides an optionee or even if the seller removes the property from the market during the term of the listing. In Ratner v. Coral Television Corporation, 139 So. 2d 437 (Fla. 3d Dist. Ct. App. 1962), the agreement provided that the optionee-buyer would pay the broker's commission in the event that the option was not exercised. The court held that the broker was entitled to his commission when the option time passed even though the option was extended because the broker was not a party to the extension nor had he consented to it. *See generally* Annotation, *Broker's Right to Commission from Principal upon Procuring Third Party Taking an Option*, 32 A.L.R.3d 331 (1970).

30. Marathon Realty Corp. v. Gavin, 224 Neb. 458, 398 N.W.2d 689 (1987).

31. DaLee Realty, Inc. v. Kuhl, 209 Neb. 6, 305 N.W.2d 891 (1981).

tion for the option.[32]

Either the prospective optionor or the prospective optionee could make the offer to enter the option contract. The Restatement (Second) of Contracts defines an offer as:

> An offer is the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.[33]

The offer must manifest the willingness to enter into the option.[34] An offer which is not sufficiently definite would, even if accepted, lead only to an illusory contract, that is, an agreement to agree.[35] Consequently, a landowner's statement to some of his tenants that "when he decided to sell, if the price were right and could be agreed on, and if conditions were right, and he was ready to sell, he would give the tenant a chance, or a first chance to buy" was not sufficient to create an option.[36] The landowner never manifested an intent to give the tenants the choice of whether to accept or not because he never had such an intent. He retained the power to decide when to sell, to whom he would sell and on what terms.[37]

An acceptance is a manifestation that the offeree agrees to the

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32. *See* RESTATEMENT (SECOND) OF CONTRACTS § 25 (1981). "Option Contracts. An option contract is a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer."

Concerning an option, the Restatement goes on to specify that:

"(1) An offer is binding as an option contract if it

(a) is in writing and signed by the offeror, recites a purported consideration for the making of the offer, and proposes an exchange on fair terms within a reasonable time; or

(b) is made irrevocable by statute."

Note, however, that the requirement of a writing even for an option to purchase real estate, is far from unanimous. *See supra* text accompanying notes 9-10.

33. *See* RESTATEMENT (SECOND) OF CONTRACTS § 24 (1981).

34. Thus, a prospective buyer's belief that he had a first option to purchase the property according to the terms of the vendor's counteroffer, pending his decision whether or not to accept, was mistaken because, *inter alia*, the vendor had not made an offer to hold that counteroffer open. Normile v. Miller, 313 N.C. 98, 326 S.E.2d 11 (1985).

35. Christmas v. Turkin, 148 Ariz. App. 602, 716 P.2d 59 (1986); Weitzman v. Steinberg, 638 S.W. 171 (Tex. App. 1982).

36. Hood v. Hawkins, 478 A.2d 181, 184 (R.I. 1984).

37. *Id.* The court, however, does not use the term offer, but speaks instead in terms of granting a power to accept.

offered terms,[38] the point being to establish that there is a meeting of the minds of the parties.[39] Whether acceptance is to be manifested by a promise or by performance or both depends on the terms of the offer.[40] However, if the offer does not limit the means of acceptance, then it can be by any reasonable means and through any reasonable medium.[41] This acceptance of the offer to enter an option is to be distinguished from the exercise of the option[42] which is the acceptance of the irrevocable offer to enter the second contract, the contract of sale. An offer of an option which lacks critical details cannot be accepted because there is no meeting of the minds as to the details of the contract of sale which would arise if the option were accepted.[43]

Consideration is needed to make the option contract binding and the offer to enter into the sales contract irrevocable.[44] Absent consideration, the offer is revocable at any time before it has been accepted.[45] It is not necessary to have separate consideration for an option which is part of a larger transaction for which the optionee has given consideration, such as a contract of sale with an option to purchase additional land,[46] a lease,[47] or a repurchase option in a deed.[48]

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38. Hoover Community Hotel Corp. v. Thomson, 167 Cal. App. 3d 1130, 213 Cal. Rptr. 750, (1985); Madison v. Marlatt, 619 P.2d 708 (Wyo. 1980); Jones v. Nunley, 547 P.2d 616 (Ore. 1976). *See also* RESTATEMENT (SECOND) OF CONTRACTS § 50(1) (1981).

39. Bucciero v. Drinkwater, 13 Mass. App. 551, 434 N.E.2d 1315 (1982). Accordingly, the lack of essential elements would render an option invalid. Reynolds v. Sullivan, 136 Vt. 1, 383 A.2d 609 (1978); Rolfs v. Mason, 202 Va. 690, 119 S.E.2d 238 (1961); Bonk v. Boyajian, 128 Cal. App. 2d 153, 274 P.2d 948 (1954).

40. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 30(1) and 50(2) (1981).

41. *See id.* § 30(2) (1981).

42. Discussed *infra* section III.

43. Goodman v. Goodman, 290 So. 2d 552 (Fla. 1st Dist. Ct. App. 1973).

44. Behrman v. Max, 102 Fla. 1093, 137 So. 120 (1931); Donahue v. Davis, 68 So. 2d 163, 170 (1953); Carter Oil Co. v. Owen, 27 F. Supp. 74 (E.D. Ill. 1939). *See also* Foy v. Foy, 484 So. 2d 439 (Ala. 1986); The Restatement, Contracts, Second § 25 defines option contract as "a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer." Comment d to this section of the Restatement points out that "[a] revocation by the offeror is not of itself effective, and the offer is properly referred to as an irrevocable offer."

45. Accordingly, an option not supported by consideration would be revoked at the optionor's death even though it was expressly intended to be exercised against the optionor's estate after the optionor's death. Crowley v. Bass, 445 So. 2d 902 (Ala. 1984). *See also* Normile v. Miller, 313 N.C. 98, 326 S.E.2d 11 (1985).

46. O'Brien v. R-J Development Corp., 387 N.W.2d 521 (S.D. 1986); Brooks v. Terteling, 107 Idaho 262, 688 P.2d 1167 (1984). *See also* Baker v. Jellibeans, Inc., 252

However, a minimal consideration may be enough. In an extreme case, the buyers had entered into a written agreement which acknowledged the receipt of $1000 towards the purchase price of a certain condominium which was then under construction. The agreement provided that the buyer had the right to purchase at a specified price and that, upon completion of the unit, the purchaser would be given notice and furnished with a purchase contract. The purchaser would then have fourteen days to decide whether to sign the contract or to cancel and have the deposit returned with interest. When the seller unilaterally decided that the price was going to be raised, the buyer sued for breach of the contract. The appeals court decided that if a jury found that the buyer has suffered some detriment and inconvenience in being deprived of the use of the money during the time when it was held on deposit or determined that the seller had derived a benefit in being able to use the option agreements as a vehicle for further promotion of other sales, for example, inducing others to buy, then the option would not fail for lack of consideration.[49] That the option had been acquired for minimal or even nominal consideration would not serve to make the option ineffective and the offer revocable.[50]

Historically, an offer could also be made irrevocable by being under seal.[51] Some states now consider a seal to have the effect of merely raising a rebuttable presumption that there was consideration.[52]

Ga. 458, 314 S.E.2d 874 (1984) (an option to purchase one lot given as part of a transaction involving the sale of three lots, would not require separate consideration).

47. Hennessey v. Price, 96 Nev. 33, 604 P.2d 355 (1980).

48. Wells v. Gootrad, 112 Idaho 912, 736 P.2d 1366 (1987).

49. Benson v. Chalfonte Dev. Corp., 348 So. 2d 557 (Fla. 4th Dist. Ct. App. 1976).

50. *See* Restatement (Second) of Contracts § 87, comment b (1981). "Nominal Consideration: Offers made in consideration of one dollar paid or promised are often irrevocable. . . .[C]ourts do not ordinarily inquire into the adequacy of the consideration bargained for." *See also* Crawford v. Deshotels, 359 So. 2d 118 (La. 1978) (a nonlawyer optionee's preparing and obtaining quitclaim deeds needed to perfect the optionor's title was sufficient consideration for the purchase option); Carter Oil Co. v. Owen, 27 F. Supp. 74 (E.D. Ill. 1939) (an implied obligation that lessee will develop oil fields would be sufficient consideration).

51. Carter Oil Co. v. Owen, 27 F. Supp. 74 (E.D. Ill. 1939). *See* Restatement (Second) Contracts § 25 (1981) comment (c). "Types of Option Contracts: The traditional common-law devices for making an offer irrevocable are the giving of consideration and the affixing of a seal." *Id. See also* Restatement (Second) of Contracts § 95 (1981).

52. *See, e.g.*, Scoville v. Scoville, 40 So. 2d 840 (Fla. 1949) which concerned a sealed deed; McGill v. Henderson, 98 So. 2d 791 (Fla. 1957) which concerned a release

The use of a seal will probably soon be universally considered to be an anachronism[53] and an option under seal,[54] prior to acceptance, merely a revocable offer, if the optionor could show the lack of consideration.

Even absent consideration, an option may be enforced based on promissory estoppel. According to the Restatement,

> (2) An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice.[55]

Divisible option contracts may present a special problem. The Restatement refers to a contract which is produced by "[a]n offer contemplating a series of independent contracts by separate acceptances"[56] and states the rule that they "may be effectively revoked so as to terminate the power to create future contracts, although one or more of the proposed contracts have already been formed by the offeree's acceptance." However the Drafter's Comment points out that:

> It is possible to make a divisible offer irrevocable, not just as to the contracts already formed by acceptances, but also as to the power to create future contracts. An irrevocable divisible offer is in effect a series of binding option contracts, but all may be made binding by a single consideration or a single formal document.[57]

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under seal.

53. *See* UNIFORM LAND TRANSACTIONS ACT § 1-307, (1977), which, if adopted by a state legislature, would eliminate the use of seals and sealed instruments in real estate transactions such as options.

54. However, until the total disappearance of the seal, it is necessary to be alert since modern permutations may be considered a seal. *See, e.g.*, FLA. STAT. § 695.07 (1985), which provides that "[a] scrawl or scroll, printed or written, affixed as a seal to any written instrument shall be effectual as a seal."

55. *See* RESTATEMENT (SECOND) OF CONTRACTS § 87 (1981).

56. *Id.* § 47 (1981).

57. *Id.* comment c (1981). *See* Osborn v. H.D.H., Inc., 192 So. 2d 22 (Fla. 4th Dist. Ct. App. 1966) (The buyer was purchasing 46 lots and the agreement gave him the option to purchase an additional 54 lots the following year and 100 lots each year thereafter until a total of 420 lots had been purchased. When a problem in interpreting the options arose, the court held that the agreements were separate and distinct arrangements for the purchase and sale of additional lots.)

An offer can only be accepted while it is still on the table.[58] If the offer is withdrawn or otherwise terminated prior to acceptance, no contract of sale is created.[59] Similarly, an attempt to exercise an option after it has expired would be ineffective because, having failed to produce a meeting of the minds, no contract of sale is produced.[60]

Ordinarily an offer is revoked by the death of either the offeror or the offeree, but an option is an irrevocable offer and, consequently, it is not ordinarily revoked by death.[61] Moreover, an option is not terminated by the optionee's offering to purchase on other terms or refusing to exercise the option prior to expiration. The Restatement (Second) of Contracts summarizes:

> . . . the power of acceptance under an option contract is not termi-

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58. Of course, it can be extended by agreement or the optionor can waive the expiration. *See* Ratner v. Coral Television Corp., 139 So. 2d 437 (Fla. 3d Dist. Ct. App. 1962).

59. Foy v. Foy, 484 So. 2d 439 (Ala. 1986). *See also* Echols v. Bloom, 485 S.W.2d 798 (Tex. Ct. App. 1972) (The court first concluded that a purported earnest money contract was in fact an option and then concluded that the option was not supported by consideration since the earnest money had not actually been deposited until after the option/offer had been withdrawn.)

60. *See* RESTATEMENT (SECOND) OF CONTRACTS § 63, comment f (1981).

> . . . Option contracts are commonly subject to a definite time limit, and the usual understanding is that the notification that the option has been exercised must be received by the offeror before that time. Whether or not there is such a time limit, in the absence of a contrary provision in the option contract, the offeree takes the risk of loss or delay in the transmission of the acceptance and remains free to revoke the acceptance until it arrives. Similarly, if there is such a mistake on the part of the offeror as justifies the rescission of his unilateral obligation, the right to rescind is not lost merely because a letter of acceptance is posted.

61. *See* RESTATEMENT (SECOND) OF CONTRACTS § 48 (1981). "Death or Incapacity of Offeror or Offeree. An Offeree's power of acceptance is terminated when the offeree or offeror dies or is deprived of legal capacity to enter into the proposed contract." *Id.* However Comment d to this section points out that: "[t]he rule stated in this section does not affect option contracts. . . . But the death or incapacity of one of the parties may discharge any contractual duty by reason of failure of consideration, frustration, impossibility or failure of condition." *But see* Fisher v. Fisher, 23 Mass. App. Ct. 205, 500 N.E.2d 821 (1986) (a right of first refusal was terminated by the deaths of the optionees due to its reference to the optionees by personal terms and the lack of suitable terms, such as heirs and assigns, to indicate the right was intended to survive their deaths); Brauer v. Hobbs, 151 Mich. App. 769, 391 N.W.2d 482 (1986) (a right of first refusal, exercisable if the vendor was ready to sell, would be terminated by her death).

nated by rejection or counter-offer, by revocation, or by death or incapacity of the offeror, unless the requirements are met for the discharge of a contractual duty.[62]

III. Exercising a Purchase Option

Exercising a purchase option is the equivalent of accepting an offer to enter into a bilateral purchase contract.[63] Whether there has been such an acceptance as to create a binding contract is determined by normal rules of contract formation.[64] Generally, that involves notifying the optionor that the option has been exercised,[65] but the parties could agree to a method of exercising the option that requires something other than, or more than, notification. For example, the option may specify that to exercise the option requires making a payment of part or all of the purchase price[66] or the payment of a mortgage.[67]

As the Georgia Supreme Court pointed out, "[b]ecause of the singular one-sidedness of an option contract in creating, for a stated duration, an irrevocable offer of the optionor, the law requires that the optionee perform all of its obligations under the contract with particular timeliness."[68] Accordingly, time is considered to be of the essence in exercising an option even if that is not expressed.[69] The logic behind

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62. *See* RESTATEMENT (SECOND) OF CONTRACTS § 37 (1981).
63. Cochran v. Taylor, 273 N.Y. 172, 184, 7 N.E.2d 89, 93 (1937).
64. Goodman v. Goodman, 290 So. 2d 552 (Fla. 1st Dist. Ct. App. 1973).
65. Orlando Realty Board Bldg. Corporation v. Hilpert, 113 So. 100 (Fla. 1927). MacArthur v. North Palm Beach Utilities, Inc., 202 So. 2d 181, 185 (Fla. 1967) (A letter notifying the optionor that it is the formal notice that the option is being exercised was held sufficient.)
66. *See, e.g.*, Romain v. A. Howard Wholesale Company, 506 N.E.2d 1124 (Ind. App. 1987). *See also* TST Ltd., Inc. v. Houston, 256 Ga. 679, 353 S.E.2d 26 (1987) (The option was to be exercised by concluding the transfer, *i.e.*, closing and paying the purchase price, after giving five days written notice to the optionor.)
67. August Tobler, Inc. v. Goolsby, 67 So. 2d 537 (Fla. 1953) (The seller took back a purchase money mortgage which included the option to buy certain surrounding land but expressly conditioned upon the payment of the mortgage debt. When the mortgage went into default, the option was terminated.)
68. *TST*, *supra* n.66, 256 Ga. at 680, 353 S.E.2d at 27, *quoting* from Barkley-Cupit Enterprises, Inc. v. Equitable Life Assurance Soc'y of the United States, 157 Ga. App. 138, 141, 276 S.E.2d 650, 654 (1981).
69. Howard Cole & Co., Inc. v. Williams, 27 So. 2d 352, 356 (Fla. 1946); Socony-Vacuum Oil Co. v. Pabian, 32 N.J. Super. 390, 396, 108 A. 2d 503, 505 (Ch. Div. 1954). *See* Annotation, *Timeliness Of Notice Of Exercise Of Option To Purchase*

this is that "[w]hen the time expires, the option holder has received the full agreed equivalent of the price he paid for his option."[70] So the optionee who fails to exercise the option in time is not losing or forfeiting anything because its contract rights terminated by their own terms.[71] However, any requirements may be voluntarily or accidentally waived by the optionee.[72] In addition, an optionee is considered to exercise the option by filing suit to enforce it.[73]

An acceptance must match the terms of the offer. Any variation of the terms would reduce the communication to a counter offer. Accordingly, the rule for exercising an option to purchase has been expressed as follows:

> [T]o exercise the option to purchase under an option contract, thus imposing a duty on the vendor to convey the land in accordance with the terms and conditions provided therein, the vendee must strictly comply with the applicable provisions of the contract. It is necessary that the optionee accept the terms of the option unqualifiedly. . .[74]

Realty, 87 A.L.R.3d 805 (1978); Annotation, *Time Specified In Real-Estate Contract For Giving Notice Of Exercise Of Option To Purchase As Of Essence*, 72 A.L.R.2d 1127 (1960). *But see* Tarlo v. Robinson, 118 A.D.2d 561, 499 N.Y.S.2d 174 (App. Div. 1986); S.B.R.'s Restaurant, Ltd. v. Towey, 130 A.D. 2d 645, 515 N.Y.S.2d 573 (1987).

In contrast, time may not be of the essence in the performance of other obligations. *See, e.g.*, Davis v. Moseley, 155 So. 2d 884 (Fla. 1st Dist. Ct. App. 1963) (obligation to accept title under repurchase option prior to receiving the showing that title was unencumbered); Cox v. Bellamy, 93 So. 2d 64 (Fla. 1957) (obligation to bring suit to quiet title).

70. *Romain, supra* n.66, 506 N.E.2d at 1127 *citing* 1 A CORBIN, A COMPREHENSIVE TREATISE ON THE WORKING RULES OF CONTRACT LAW § 273 (1963).

71. *TST, supra* n.66, 256 Ga. at 80, 353 S.E.2d at 27.

72. *See, e.g.*, Siders v. Odak, 126 A.D. 2d 292, 513 N.Y.S. 2d 549 (App. Div. 1987) (The requirement of written notification was verbally waived by the optionor.) *See also TST, supra* n.66 256 Ga. at 680, 253 S.E.2d at 27 (No waiver was found because of the failure to allege the elements of waiver, *i.e.*, acts or statements from which the intent to waive could reasonably be inferred.)

73. But a suit to specifically enforce a sales contract in which the buyer also acquired options to purchase additional lots would not have the effect of exercising the additional options. The buyers, who were successful in their action for specific performance, would be able to exercise those options in the future. O'Brien v. R-J Development Corp., 387 N.W.2d 521 (S.D. 1981), *modified on reh'g* at 398 N.W.2d 132 (S.D. 1986), but note the dissent of Justice Henderson, at 134.

74. Mathews v. Kingsley, 100 So. 2d 445, 446 (Fla. 2d Dist. Ct. App. 1958) (citation omitted) (The buyers had attempted to exercise the option but also sought to

In discussing options, the Restatement expresses the same sentiment. "The offeror's duty of performance under any option contract so created is conditioned on completion or tender of the invited performance in accordance with the terms of the offer."[75] However, that is not meant to indicate that an optionor may seize upon the slightest discrepancy to avoid his obligations under the option. A notice will still be effective even if it varies from the terms of the option if the optionee has clearly intended to unconditionally exercise the option according to its terms,[76] particularly where the optionor has suffered no harm.[77]

Where an option is granted to co-optionees who do not act in concert to exercise the option, the requirement that the option be exercised in strict conformance with its terms is applied. If express terms have not been provided to deal with this possibility, there are two questions: can the option be exercised by less than all the co-optionees; and, if so, what is the effect of such a less-than-all exercise on the rights of the other optionees. Courts are likely to determine that co-optionees must jointly exercise the option, an attempt by less than all being ineffective.[78] However, the court may decide that each optionee has the power to accept the offer embodied in the option, so an attempt by a co-optionee to exercise would be effective, but the relative rights of the optionees should be determined according to the rules of equity in an interpleader action.[79]

Exercising an option does differ from accepting an offer in one significant way. There is no "mail box rule"[80] for exercising options.[81] The

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change the terms, avoiding the payment of a brokerage commission and making a smaller cash payment than proposed in the offer.)

75. RESTATEMENT (SECOND) OF CONTRACTS § 45(2) (1981).

76. Birkmeier v. Herget Nat'l Bank of Pekin, 102 Ill. 2d 548, 468 N.E.2d 1220 (1984).

77. *See, e.g.*, Stoffer v. Adams, 54 So. 2d 801 (Fla. 1951) (The optionee offered the optionor a first mortgage to secure the monthly payments of part of the purchase price when the option required only a second mortgage.)

78. *In re* Estate of Maguire v. McNutt, 204 Kan. 686, 466 P.2d 358 (1970); Myers v. Western Realty & Constr., Inc., 130 Ariz. 274, 635 P.2d 867 (Ariz. Ct. App. 1981).

79. For example, the optionor should tender his performance to the court and let the co-optionees fight it out amongst themselves. R.H. Pierce Manufacturing Corporation, v. Continental Manufacturing Co., Inc., 106 Idaho 342, 679 P.2d 142 (1984).

80. Under the "mail box" rule, an acceptance is effective the moment that it is put out of possession, such as into the mail box.

81. As the Restatement explains, while ordinarily an acceptance may be made "in a manner and by a medium invited by an offer" and it is "operative and completes

acceptance of an ordinary contract offer is effective when sent. In contrast, whatever notification or payment by the optionee is to be the means of accepting that offer, it is not effective until received. As one court explained, "the very nature of an option contract compels us to view the 'mailbox rule' of acceptance as inapplicable. . ."[82] because that would alter the agreement by giving the optionee more time than had been agreed upon.[83]

An implied covenant of good faith may prevent an optionor from undermining the optionee's attempts to exercise the option.[84] However, in the event that the attempt to exercise the option is defective, the optionor does not have the duty of communicating that to the optionee, nor does the optionor have a duty to inform the optionee how to cure the defect. In *Koplin v. Bennett*,[85] the court stated that:

> We find no rule of law to the effect that the optionee, by serving on [the] optionor an inadequate notice of election to exercise the option, casts on the optionor any duty to instruct or inform the optionee of the particulars in which the election to exercise the option fails to meet the terms and conditions thereof; nor do we find that under such circumstances the optionor is required to take any affirmative action on the theory that the optionee will amend or correct an inadequate acceptance.[86]

However, it seems likely that courts in the future, borrowing the requirement of good faith implied into contracts governed by the Uniform Commercial Code,[87] will find that the duty of good faith also binds an optionor to notify the optionee if an attempted exercise of the

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the manifestation of mutual assent as soon as put out of the offeree's possession, without regard to whether it ever reaches the offeror; but (b) an acceptance under an option contract is not operative until received by the offeror." RESTATEMENT (SECOND) OF CONTRACTS § 63 (1979).

82. Romain v. A. Howard Wholesale Co., 506 N.E.2d 1124, 1127 (Ind. Ct. App. 1987).

83. *Id.* at 1128.

84. Stockton v. Sowerwine, 690 P.2d 1202 (Wyo. 1984).

85. 155 So. 2d 568 (Fla. 1st Dist. Ct. App. 1963).

86. *Id.* at 573.

87. *See, e.g.*, contracts for the sale of goods, commercial paper, documents of title, etc. *See* U.C.C. § 1-203 (1977), "Obligation of Good Faith. Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." A similar obligation had been proposed for real estate contracts by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in the Uniform Land Transactions Act § 1-301 (1977).

option is defective.

An offer can provide that its acceptance be by performance rather than by giving a promise in exchange. The parties could agree that the performance invited is payment of the purchase price.[88] While such an option might be reasonable in the purchase of goods, it invites problems where real estate is being bought because the potential for title problems mandates a title search prior to a buyer accepting title.[89] Title searches, even under ideal conditions, take time. Absent a contrary agreement, an option is exercised by notice which allows time for a title search prior to the required closing.[90] Consequently, absent a clear expression to the contrary, an option will not be interpreted to require tender of payment to be exercised.[91] However, the optionor may not prevent the optionee from satisfying the terms. For example, if the option requires that the closing must take place within a certain period, the optionor's refusal to show up for a closing would not prevent the optionee from successfully exercising the option by giving notice of his intent to perform and standing ready to do so within the specified period.[92]

It should be remembered that the option and the sales contract, which is formed when the option is exercised, are two different contracts. Consequently, the discussion about the rules for exercising the option should not be mistaken for rules regarding performance of the obligations under the sales contract. Consistent with this distinction, performance of the obligations under the contract, for example, payment of the purchase price, is not required within the option period unless that is expressed or necessarily implied.[93]

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88. *See*, RESTATEMENT (SECOND) OF CONTRACTS § 45 (1979). "OPTION CONTRACT CREATED BY PART PERFORMANCE OR TENDER. (1) Where an offer invites an offeree to accept by rendering a performance and does not invite a promissory acceptance, an option contract is created when the offeree tenders or begins the invited performance or tenders a beginning of it."

89. *See* § V.E. *infra*.

90. Exercising an option by paying the purchase price prior to a title search would be reasonable for the buyer only if the price, or a significant part of it, were to be escrowed and released to the seller only after completion of a satisfactory title search and elimination of any title defects or clouds revealed by the search.

91. Hilltop Development v. Miller Hill Manor Co., 342 N.W.2d 344 (Minn. 1984).

92. *Id.*

93. *See, e.g.*, Siders v. Odak, 126 A.D.2d 292 523, N.Y.S.2d 549, (1987) (where the court held that a three year option requiring thirty days notice could be exercised at any time during the three years creating the bilateral contract of sale which could be

An option may be made subject to a condition precedent. The power to exercise the option would be subject to the occurrence of an event. In one example, an employer had conveyed land to his employee as a site for the employee's home but subjected the conveyance to a repurchase option.[94] When the employee ceased working for the grantor on the grantor's ranch, which surrounded the land in question, the grantor could repurchase the land from the former employee. Another example involved an option on an option. The optionor did not actually own the land involved, but merely had an option on it. He had agreed that if he exercised his option to purchase the land, his optionee would have an option to purchase from him. That option was subject to a condition precedent, the optionor exercising the other option first.[95] Similarly, the failure of a condition subsequent, such as obtaining a zoning change, may release the optionee from the sales contract created when the option was exercised.[96]

IV. The Uses of Purchase Options

A. *In General*

Purchase options are frequently used as tools for structuring real estate transactions.[97] A developer may use purchase options to assemble the land for a large project, acquiring options on parcels one by

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performed according to its terms after the three year period); Lewis v. Chase, 23 Mass. App. Ct. 673, 505 N.E.2d 211 (1987) (where the requirement of between thirty and ninety days notice was held to define the time for the closing if the option was exercised and not the time within which to exercise the option). *See also* Annotation, *Necessity For Payment Or Tender Of Purchase Money, Within Option Period To Exercise Option, In Absence Of Specific Time Requirement For Payment*, 71 A.L.R.3d 1201 (1976).

94. Wells v. Gootrad, 112 Idaho 912, 736 P.2d 1366 (1987). The court held that even though the optionor had ceased working involuntarily due to his leukemia, that event triggered the seller's right to repurchase under the terms of the option.

95. Shelton v. Eisemann, 75 Fla. 644, 79 So. 75 (1918).

96. *See, e.g.*, Annotation, *Effect Of Provision In Real-Estate Option Or Land Sale Contract Making The Contract Subject To Zoning Or Rezoning Of The Property*, 76 A.L.R.2d 1195 (1961).

97. Purchase options are the norm. However, on occasion one sees an option to sell which binds the buyer to complete the purchase if the seller should decide to sell. *E.g.*, Skeen v. Clinchfield Coal Corp., 137 Va. 397, 119 S.E. 89 (1923) where the deed provided that the purchasers of a tract from which a homesite was reserved were bound to purchase the homesite at a fixed price if the owners ever decided to sell it. The option, however, was held to violate the Rule against Perpetuities. *See infra* text § 5.D.

one, until the needed land is under option. He avoids acquiring or even obligating himself to acquire any land until he has decided that he can acquire all the land needed for the successful development. If he is unable to assemble all he needs, he can abandon the project and not exercise the options. All he has lost is the cost of the options, which is small in comparison to the what he would have spent in buying the land.[98] Having abandoned the project, he is not burdened with land which he does not need, nor bound by sales contracts under which he may forfeit large deposits or be subjected to lawsuits for damages or specific performance.

Land assembly is not the only reason developers use purchase options. Their use can make it possible to perform feasibility or market studies and explore the possibilities of financing. If the rights were not acquired prior to making the studies or the inquiries, the notoriety of proposed development might drive up the prices, making the project too expensive, inviting competition, or even making current owners unwilling to sell their land. Also, locking in the price of the land eliminates one variable, the cost of the land, from the study, making the study's projections more likely to be accurate. By using purchase options, the optionee acquires, for a minimal price, the time within which to get the information needed to decide whether to go forward with the project. In addition, to qualify for an otherwise unavailable financing or grant program, a developer may transfer the land to an eligible entity, but retain a repurchase option.[99]

Options may also be used to help a developer finance a project where the construction is to be sequential. Rather than purchase the land himself, the land is purchased by the financier who is in a much more secure position owning the land than if he were merely a mortgagee. The developer has the option to purchase parcels of the land, either when it is ready to begin construction or when the construction is completed and a buyer is under contract. The effect is to have the lender warehouse the land, allowing the developer to call it from the

98. Of course, the cost of the options will depend on the value of the property, the existence of other prospective buyers, the length of the option and the negotiating skill of the buyer.

99. *See, e.g.*, Town of Eustis v. Stratton-Eustis Development Corp., 516 A.2d 951 (Me. 1986). The town wanted to develop a campground using a loan from FHA, but was ineligible so it created the Corporation as a "financial conduit" to borrow the money. Unfortunately, the conveyance to the Corporation, rather than retaining an option, only gave the town a right of first refusal, and the town's efforts to reclaim the land by the vehicle of a constructive trust failed.

inventory at an advantageous time.[100]

Developers are not the only buyers to use purchase options. Where the buyer's desire to purchase depends on contingencies which cannot or will not be reduced to objective standards, the parties may be better off utilizing an option rather than a contract with vague conditions which will ultimately lead to litigation for clarification.[101] The purchase option is also an ideal tool for speculation. The speculator, seeing a property which he thinks is marketable, acquires an option on it. If a buyer can be located within the option period, the speculator profits by selling the option or exercising it and later selling the contract or the property itself. If no profitable sale can be arranged, the speculator takes the cost of the option as a loss. This led to the charge in one case that options should be held void as gambling contracts. However, the Georgia Supreme Court refused the invitation to reach that conclusion.[102]

An option is also an appropriate device where the parties have agreed to the sale of part of the seller's property but have left it to the buyer to decide exactly which parcel.[103] A seller may also entice a prospective buyer to purchase one property with an option on another property, possibly conditioned upon some other event[104] such as further development at a later time.[105] Conversely, a landowner may sell his land subject to a repurchase option if development does not proceed

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100. *See, e.g.*, Connor v. Great Western Savings and Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1969). Note however, the court in that case held that the lender could be held liable for construction defects due to the magnitude of its involvement in the development process. *See* OSBORNE, NELSON AND WHITMAN, REAL ESTATE FINANCE LAW § 12.11 (2d ed. 1979); Annotation, *Financing Agency's Liability to Purchaser of New Homes or Structures for Consequences of Construction Defects*, 39 A.L.R.3d 247 (1971).

101. *See* Tempkin, *Too Much Good Faith in Real Estate Purchase Agreements? Give Me An Option*, 34 U. KAN. L. REV. 43 (1985).

102. Baker v. Jellibeans, Inc., 252 Ga. 458, 314 S.E.2d 874 (1984).

103. However, it would not be an option if the parties were subsequently to agree on the boundaries, rather than leaving the choice to be made by the optionee unilaterally. Turner v. Hostetler, 359 Pa. Super. 167, 518 A.2d 833 (1986).

104. The conditional option might be a right of first refusal, discussed *infra* in III.A, or based upon some other condition precedent, *e.g.*, the death of the seller or the passage of a certain number of years.

105. *See* Baker v. McCarthy, 122 N.H. 171, 443 A.2d 138 (1982), where a lot set back from the beachfront seemed more desirable when combined with an option to obtain the land between it and the beach.

according to plan.[106] Co-landowners may provide for a buy-out option in the event one of them dies[107] or wants to leave their joint venture. Options are also used as a vehicle for restructuring transactions for tax purposes.[108]

A business or a home-buyer may want to try out a location before making a purchase commitment.[109] However, an option would not entitle the optionee to possession. Granting the optionee a license to be on the premises may be sufficient for a short term try-out but would be inadequate for many purposes because it would not give the optionee any possessory rights during that period. For the optionee to have possessory rights would require a lease being granted in addition to the option.

B. *Lease-Options*

A lease may include an option to purchase, an option to renew for another term, or both,[110] but the discussion here is limited to options to purchase the property. While an option must be supported by consideration to become enforceable, separate consideration is not required for the option contained in a lease.[111] The parties may wish to allocate

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106. *See* Trailsend Land Co. v. Virginia Holding Corp., 228 Va. 319, 321 S.E.2d 667 (1984), noting, however, that the court interpreted the repurchase option to be a condition subsequent to the grantee's estate.

107. Layne v. Henderson, 232 Va. 332, 351 S.E.2d 18 (1986).

108. *See* Hemsley v. Pannick, 131 AD.2d 940 516 N.Y.S.2d 804, (1987). A person who was land rich but in need of cash approached his physician for a loan. The physician's accountant suggested that they structure the arrangement as sales subject to options to repurchase on the borrower's land, rather than loans secured by mortgages on that land, so that the physician would have the benefit of capital gains tax treatment. Title problems prevented the repurchase and the court invoked the parol evidence rule to limit the physician to the remedy specified if title problems arose, the return of the consideration for the option. *Also see* discussion *infra* in § IV.D regarding convertible mortgages.

109. *See* Duncan v. G.E.W., Inc, 526 A.2d 1358 (D.C. 1987), where the purchaser of a chain of restaurants, rather than purchasing the locations, obtained leases with purchase options. This minimized the risk because any location which was unsuccessful could be abandoned when the lease expired. Furthermore, this minimized the cash needed to acquire the chain. Thus the buyer had more money to invest in the improvement and promotion of the restaurants during the critical start-up phase. *See also* Lease-Options discussed *infra*.

110. *See* 2 M. Friedman, Friedman on Leases (2d Ed.) 757 (1983); 1 American Law of Property §§ 3.82-3.84 (1952).

111. A particularly difficult question is whether the renewal of the lease a

between rent and the cost of the option due to the different tax treatment of each.[112] The lease with a purchase option is often used to entice hesitant buyers. The theory is that the leases and options are much less threatening to potential buyers than are purchase contracts. The seller reasons that once the potential buyer is in possession, particularly living in a residence, it will be much easier to convince him to stay put and make the purchase, counting possibly on the factor of inertia, that is, a body at rest tends to remain at rest.

The seller may also be able to attract buyers who could not otherwise afford to make the purchase. Most institutional mortgages require a down payment. The seller can attract buyers who do not have the necessary down payment by promising to credit part, or all, of the rental payments towards the purchase price. At a minimum, an option promises to hold the price constant while the optionee tries to save up or borrow money for the down payment. The potential buyer may be more likely to lease the property knowing what the eventual purchase price would be and having the time to decide if he wants to make the purchase. For a business, the lease-option gives it a chance to test the suitability of a location before making a purchase commitment.

The lease-option provides the seller with benefits in addition to potential buyers. During the lease term, the property will produce regular income. If the owner is under the pressure of making mortgage payments on the property, the lease-option may off-set the cash flow drain of the mortgage payments and may even produce some profit. In addition, the property is occupied rather than remaining empty. Even if this lessee-optionee does not make the purchase, it may facilitate the sale to a third party because it is generally considered easier to sell an occupied property than a vacant one and occupied properties are not as likely to be subjected to vandalism or theft.

Coupling the option with a lease may provide some difficult

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extends the tenant's option for the duration of the new lease term. In Sisco v. Rotenberg, 104 So. 2d 365 (Fla. 1958), the Florida Supreme Court, citing what it labeled the majority rule, held that an option for which separate consideration had not been paid was not an independent or collateral covenant. Consequently, extension of the lease also extended the option.

112. The payment for the option is not recognized as income to the optionor until the option either expires or is exercised. If exercised, the option payment is treated as part of the purchase price of the property. For the optionee, the option price is then added to the cost basis of the purchased property. The cost of an option which was allowed to expire would be treated as a loss from the sale of underlying property. *See* SAMANSKY AND SMITH, FEDERAL TAXATION OF REAL ESTATE § 7.01[5][a].

problems regarding the interaction of landlord-tenant law and option law. For example, the tenant's default on the obligations under the lease may affect his right to exercise the option,[113] and the premature termination of the lease would normally terminate the tenant's rights under the option.[114] The tenant who has held over after the expiration of the lease may be unable to exercise the option, but the tenant who has extended or renewed his lease should still be able to exercise the option during the renewed or extended period.[115] Whether a rent control statute would affect the landlord's ability to charge additional for an option to purchase in a rent controlled unit would depend on the particularities of that statute.[116] Careful drafting of the lease and the option may resolve many of the lease-connected issues.

Another version of the lease-option is the lease-purchase contract.[117] Under this, the tenant has the right to take title when all the payments specified total up to the purchase price. Otherwise, the payments are treated as rent. Essentially, the buyer has the option which is exercised by performance, by making the payments. This is usually structured to appear to be a contract of sale which, in the event of buyer default, limits the seller's remedies to the forfeiture of the

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113. *See* Annotation, *Lessee's Breach of or Default Under Lease Agreement as Affecting His Right in Respect of Option to Purchase Under the Lease*, 53 A.L.R.3d 435 (1973). For the opposite situation, i.e., the landlord's breach, *see* Annotation, *Tenant's Rights Under Unexercised Option to Purchase As Affected By Landlord's Breach of Lease or Lease Agreement*, 12 A.L.R.3d 1128 (1967); Annotation, 17 A.L.R.3d 976 (1968).

114. *See* Annotation, *Termination Of Lease As Termination Of Option To Purchase Therein Contained*, 10 A.L.R.2d 884 (1950).

115. III Lounge, Inc. v. Gaines, 217 Neb. 466, 348 N.W.2d 903 (1984). *See* Annotation, *Holding Over Under Lease, Or Renewal Or Extention Thereof, As Extending Time For Exercise Of Option To Purchase Contained Therein*, 15 A.L.R.3d 470 (1967). *But see* Williams v. Williams, 347 N.W.2d 893 (S.D. 1984). The South Dakota statute provides that the parties are presumed to have renewed a lease on the same terms, but an option is regarded as an independent covenant and not a term of the lease under that statute. However, the right of first refusal involved in that case was regarded as a term of the lease and, therefore, a part of the renewed lease because it limited the landlord's ability to terminate the leasehold by selling to a third party.

116. *See* Annotation, *Enforceability Of Option To Purchase, Consideration For Which Is Payment Of Rentals Exceeding Rent Control Law Maximum*, 28 A.L.R.2d 1204 (1953).

117. *See* Annotation, *Construction And Operation of 'Optional Agreement - Flat Payment' Land Contract Under Which Optionee Has Right to Take Title When Periodic Payments (Otherwise To Be Treated As Rent) Equal Agreed Price*, 55 A.L.R.3d 159 (1974).

buyer's deposit.[118]

The presence of the option may have a significant effect on the tenant's attempt to renew the lease. Ordinarily, renewal requires strict compliance with the terms of the renewal option. The strict compliance requirement is tempered somewhat when the option appears in a lease. Because failure to renew a lease would terminate not only the lease but also the purchase option, doctrine has evolved to mitigate the effect of faulty attempts to renew the lease which contains a purchase option.[119]

For example, in *Duncan v. G.E.W., Inc.*,[120] the buyer of a chain of restaurants acquired a lease from the seller for each of the restaurant sites. The identical leases each included an option to purchase as well as renewal options. The optionee/lessee's president was late in giving the renewal notice and the landlord refused to recognize the late notice. The court held that there must be strict compliance with the renewal option unless equity intervenes. Equitable relief should occur when 1) the tenant's delay was based on an honest mistake and not mere neglect, 2) the delay was slight, 3) the landlord had not relied to his detriment on the failure of the tenant to give notice, and 4) strict enforcement of the notice term would result in an unconscionable hardship for the tenant. On reviewing the factors of this case, it concluded that equitable relief would be appropriate because: the delay was only seventeen days until oral notice and twenty three days until written notice was given; the delay was based upon an honest mistake; the landlord had not relied upon the nonrenewal to his detriment; the landlord knew that the tenant intended to renew; the tenant had made substantial improvements; and the landlord would reap a windfall if renewal did not occur. Critical to the court's conclusion that the forfeiture of the lease renewal would be unconscionable was the magnitude of the loss which the tenant would suffer from the forfeiture contrasted with the landlord's unjustified gain from it.

In contrast, the late renewal notice was not effective in *Brick Plaza, Inc. v. Humble Oil & Refining Company*.[121] The tenant had constructed two buildings on the land and had rebuilt one after a fire. However, the tenant's excuse, that the late renewal was an honest mis-

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118. *See* Section I, *supra*.

119. *See* Annotation, *Circumstances Excusing Lessee's Failure To Give Timely Notice Of Exercise Of Option To Renew Or Extend The Lease*, 27 A.L.R.4th 266 (1984).

120. 526 A.2d 1358 (D.C. 1987).

121. 218 N.J. Super. 101, 526 A.2d 1139 (1987).

take based upon reliance on the terms of a preliminary unexecuted draft of the lease, demonstrated that the tenant had been negligent, particularly in light of the fact that the renewal provision was obviously the subject of specific negotiation. Furthermore, the delay of over five months was not slight. The court pointed out that equity should interfere with caution because business people need order and predictability and simply balancing the equities to determine if the delay should be excused would create intolerable uncertainty.

C. *Rights of First Refusal*

A right of first refusal is a contractual right to preempt another buyer.[122] It is also known as a preemptive right and has also been described as a "preferential right to purchase,"[123] a "first right to buy,"[124] or a "first option to buy."[125] A land seller may want this right in order to control the identity or activities of the buyer's successors. This often occurs where the seller plans to occupy, use or develop nearby property. Preemptive rights are commonly included in the articles or by-laws of condominiums or co-operatives, as well as in deeds where there is a homeowners' association. They may also occur where the owner was unwilling to sell certain property or rights at the moment, but for a price, or as an enticement,[126] is willing to give this person the first chance if he should ever change his mind.

The right of first refusal is an option to purchase which is subject to an agreed condition precedent, generally the optionor's receipt of an offer and the good faith[127] decision to accept it.[128] The occurrence of

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122. Consequently, it is often described as a pre-emptive right. It is also been termed an "independent privilege," Hood v. Hawkins, 478 A.2d 181, 185 (R.I. 1984), *citing* Butler v. Richardson, 74 R.I. 1344, 60 A.2d 718 (1945), and is also referred to as an option. *See e.g.* Iglehart v. Phillips, 383 So. 2d 610 (Fla. 1980). *See* Annotation, *Option To Purchase At Price Offered To Optionor By Third Person*, 136 A.L.R. 138 (1942).

123. Cherokee Water Company v. Forderhause, 641 S.W.2d 522 (Tex. 1982) which involved a deed in which the grantor reserved a preferential right to purchase minerals.

124. Hood v. Hawkins, 478 A.2d 181 (R.I. 1984).

125. Town of Eustis v. Stratton-Eustis Development Corp., 516 A.2d 951 (Me. 1986).

126. For example, as an enticement to purchase or lease a property, the grantee may be given the right of first refusal on the adjoining property or on the property which the grantee preferred but the owner was not yet willing to sell or rent.

127. Accordingly, a sale for one dollar for the improper purpose of defeating a

these events satisfies the condition and makes the option operative, *i.e.*, when that occurs, the right of first refusal is triggered and ripens into an option which can now be exercised.[129] An unripened preemptive right gives the holder of the right no power to force the owner to sell. The optionor must notify the right holder of his receipt of the offer and his decision to accept it, and at least one court has held that the optionee is entitled to receive a copy of the triggering offer.[130] However, a right of first refusal is not ordinarily triggered by an offer which is subject to conditions which have not been met.[131]

It seems consistent that the holder of a right of first refusal cannot exercise that right against the buyer at a forced sale, for example, a foreclosure,[132] because the conditions precedent, the offer and decision

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right of first refusal was not to be allowed. MacDonald v. Hawker, 11 Mass. App. Ct. 869, 420 N.E.2d 923 (1981). Similarly, following a conveyance for one dollar and subsequent reconveyance for the alleged purpose of defeating a right of first refusal, the court considered the case as if the transfers had not occurred. Fisher v. Fisher, 23 Mass. App. Ct. 205, 500 N.E.2d 821 (1986).

128. *See* Estate of Johnson v. Carr, 288 Ark. 461, 706 S.W.2d 388 (1986) (where the condition, that if the owner should "desire to sell," had not been satisfied by sending a letter that it was "seriously considering" selling and wanted to open negotiations); Robichaux v. Boutte, 492 So. 2d 521 (La. Ct. App. 1986) (where the optionor's letter indicating that she had received an offer but had not yet decided whether to sell did not trigger the optionee's right of first refusal and, consequently, the optionee could specifically enforce the right against the buyer); Vietor v. Sill, 243 So. 2d 198 (Fla. 4th Dist. Ct. App. 1971) (where all apartment owners had agreed to give the others the right of first refusal, an owner refused to sell to the others because she had not entered a binding contract to sell to another. The court concluded however, that the terms of the agreement did not require a binding contract to invoke the right of first refusal but merely an intention to sell). *But see* New Haven Trap Rock Company v. Tata, 149 Conn. 181, 177 A.2d 798 (1962) (where the right was triggered if the owner should "consider selling").

129. Green v. First American Bank and Trust , 12 Fla. L. Week 906, 511 So. 2d 569 (Fla. 4th Dist. Ct. App. 1987).

130. Gyurkey v. Babler, 103 Idaho 663, 651 P.2d 928 (1982), which is analyzed in Stutzman and Day, *Protecting the Preemptor: Real Property Rights of First Refusal in Light of Gyurkey v. Babler*, 19 IDAHO L. REV. 277 (1983).

131. For example, in H.G. Fabric Discount, Inc. v. Pomerantz, 515 N.Y.S.2d 823 (1987), tenants had, as a term in their lease, a right of first refusal. They declined to purchase at the price offered by a prospective purchaser who had conditioned his offer on the premises being unoccupied, a condition which was not satisfied. The court held that the tenants had not waived their right. Consequently, they could assert their right when the landlord received a subsequent purchaser.

132. *See* Annotation, *Rights Of Holder Of "First Refusal" Option On Real Property In Event Of Sale At Foreclosure Or Other Involuntary Sale*, 17 A.L.R.3d

to accept, have not occurred. If the mortgage or lien is senior to the right of first refusal, the right would be extinguished by the foreclosure.[133] Although this result would seem to defeat the intent of the parties, it should be remembered that the holder of any other subordinate right would be in the same position and the only way to be certain of acquiring the property would be to purchase it at the forced sale.

The decision of the optionor to sell a larger parcel which includes the land creates special problems. The owner may receive an offer on a larger property which includes the subject parcel. The right holder should not be forced to preempt the offer on the larger property because that purchase is larger and more costly than the one for which he bargained, and he should not lose the right to the smaller parcel for which he has paid. Conversely, he should not be entitled to a right of first refusal on the larger parcel because he did not pay for that. The seller should not, where the smaller is critical to the larger sale, have to suffer the disproportionate harm of losing the larger sale because of the need to make the smaller one. The solution, of course, is that the parties should consider the possibility and expressly provide an answer to the question of whether the parties intended that an offer on the larger parcel would trigger the right of first refusal and, if so, whether the right holder would have to match the offer on the entire parcel.

Where the parties have not foreseen the possibilities or have failed to express their agreement in clear terms, the court must struggle to determine their probable intent. No clear pattern of interpretation has emerged,[134] except that the right of first refusal cannot be intentionally circumvented by arranging to sell the subject land as a part of the larger sale.[135] In the case of a bona fide offer on the larger tract, each

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962 (1968).

133. However, if the optionee had not been joined as a party to the judicial proceeding leading to the sale or been given notice of a nonjudicial sale, the right could still be asserted against the buyer. The buyer may be protected from an unrecorded option under the state's recording system and, in any event, ordinarily may bring a subsequent reforeclosure action joining the right holder and terminating his rights.

134. *Compare* Sawyer v. Firestone, 513 A.2d 36 (R.I. 1986) (where a seller breached a contract to sell land and the right of first refusal on neighboring land by insisting that the deed specify that the right of first refusal would apply only in the event that the land was sold as a separate parcel) *with* Crow-Spieker #23 v. Robert L. Helms Construction and Development Co., 731 P.2d 348 (Nev. 1987) (where an offer to purchase the larger tract was held not to trigger the right of first refusal on the included parcel).

135. Myers v. Lovetinsky, 189 N.W.2d 571 (Iowa 1971); Maron v. Howard, 258 Cal. App. 2d 473, 66 Cal. Rptr. 70 (1968); K.S. & S. Restaurant Corp. v. Yarbrough,

case appears to turn on the equities of the situation. Ordinarily, the right holder can enjoin the sale,[136] but under certain circumstances, the right holder may lose the right,[137] may be allowed to specifically enforce the right at a proportionate price or at the fair market value,[138] or even may be limited to damages.[139]

The method of exercising a right of first refusal is the same as exercising an option because that is what the right has ripened into on the satisfaction of the conditions precedent. This was illustrated by *Pearson v. Fulton*[140] where the agreement granted a right of first refusal which would expire 120 days from delivery to the right holder of a certified copy of any executed or accepted offer. On hearing that a contract had been entered, the holder sent a letter headed by the word "notice" which stated that "we hereby elect to exercise that right of first refusal. . ."[141] and initiated suit to enforce the right. The trial court concluded that the notice exercising the right of first refusal merely began the time within which to exercise the option. The appellate court reversed. It reiterated that a right of first refusal "ripens" into an option once the owner manifests a willingness to accept a good faith offer from the third person.[142] Consequently, exercising the right of first refusal would be exercising the option.

Ordinarily, a right of first refusal will bind the optionee to

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104 A.D.2d 486, 479 N.Y.S.2d 235 (1984).

136. Guaclides v. Kruse, 67 N.J. Super. 348, 170 A.2d 488 (1961).

137. Crow-Spieker #23 v. Robert L. Helms Construction and Development Co., 731 P.2d 348 (Nev. 1987).

138. *See, e.g.*, Pantry Pride Enterprises, Inc. v. Stop and Shop Cos., 806 F.2d 1227 (4th Cir. 1986), which involved a right of first refusal to repurchase a sublease interest. The sublessee received an offer to sell its supermarkets, including the one located at the sublease. The terms of the offer allocated part of the price to acquisition of the sublease and the rest to the purchase of the equipment. The right holder attempted to exercise its right as to the sublease only, not including the equipment, at the price allocated to the sublease in the offer. The court upheld the right holder's right to acquire the sublease, but at the fair market value, not the price allocated in the offer, because that would yield a windfall for the optionee. The allocation in the offer had been legitimately structured to maximize the tax benefits.

139. *See* Stutzman and Day, *Protecting the Preemptor: Real Property Rights of First Refusal in Light of Gyurkey v. Babler*, 19 IDAHO L. REV. 277 (1983); Annotation, *Option To Purchase Real Property As Affected By Optionor's Receipt Of Offer For, Or Sale Of, Larger Tract Which Includes The Optioned Parcel*, Annotation, 34 A.L.R.4th 1217 (1984).

140. 497 So. 2d 898 (Fla. 2d Dist. Ct. App. 1986).

141. *Id.* at 899.

142. *Id.* at 900.

purchase according to the exact terms of the offer which he has preempted and, absent agreement to the contrary, that is the way a right would be construed.[143] Considering all the variable terms, besides the price, involved in a sales contract,[144] the right holder is taking a great risk of being faced with the choice of an onerous contract or losing the land. Of course, the parties could agree in advance to any or all of the terms of the contract of sale by which the preemptor could purchase, leaving only specific terms to be filled in from the preempted offer. That occurred in *Shower v. Fischer*,[145] discussed below, where the purchase price was to be ten percent below the appraised value, rather than the price of the offer which had triggered the right.

The obligation to pay a brokerage commission may produce complications. Normally, the seller contracts with a real estate broker to find a buyer and, ordinarily, the seller pays the brokerage commission out of his proceeds from the sale, but the seller may be liable for that commission under the terms of the agreement even if the property is not purchased by the person he found.[146] If the seller will be liable for

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143. Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854 (Fla. 3d Dist. Ct. App. 1970). *But see* Hood v. Hawkins, 478 A.2d 181 (R.I. 1984), holding a right of first refusal void as being too speculative where the price term is not fixed and no method was provided for fixing the price.

144. For example, type of contract (*i.e.*, is it an installment contract requiring periodic payments over a long term prior to the transfer of title to the buyer or is it an executory contract in which the entire purchase price is due shortly at an imminent closing), financing terms, right to possession prior to closing, risk of loss and cost of insurance prior to closing, conditions concerning the status of the title or defects in structures.

145. 47 Wash. App. 720, 737 P.2d 291 (1987). *See* text at note 152, *infra*.

146. The historical rule has been that, absent agreement to the contrary, the broker would be entitled to his commission when he produces a buyer who is ready, willing and able to purchase the property according to the listed terms. St. Petersburg Land & Loan Co. v. Shallcross, 84 Fla. 575, 94 So. 502 (1922); Acheson v. Smiths, Inc, 148 So. 576 (Fla. 1933). However, that rule has begun to erode because some courts have the perception that the parties expect that the commission will be paid out of the proceeds of the sale. Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 236 A.2d 843 (1967); Tristram's Landing, Inc. v. Wait, 367 Mass. 622, 327 N.E.2d 727 (1975); Caperruto v. John Hancock Mutual Life Insurance Co., 394 Mass. 399, 476 N.E.2d 188 (1985). A unilateral contract under which any broker may earn the commission by being the one to procure such a buyer is called an "open listing." However, the seller and broker may agree that this broker will be entitled a commission on the sale of the property to anyone (called "an exclusive right of sale" brokerage contract) or on the sale of the property to anyone other than a buyer procured by the seller himself (an "exclusive agency" brokerage contract). An exclusive right of sale is probably becom-

the commission regardless of who purchases, then there is no problem because the preemptor must exactly match the third party's offer. Similarly, if the third party's offer includes a term making the buyer liable for the brokerage commission,[147] then the preemptor must also agree to assume that liability even though he did not contract for the broker's services.[148] But, when the seller will not be liable to pay a brokerage commission if the property is sold to the preemptor, the question arises whether the preemptor may subtract the amount which the seller would have paid for a commission from the amount which he must pay for the property. Put more simply, must the preemptor match the other offer exactly, even though that means that the seller will reap a windfall in the amount of the brokerage commission which he will not have to pay because of the preemption, or need the preemptor only put the seller in the same position which he would have been in had the preemption not occurred.

In *Reef v. Bernstein*,[149] the court determined that the question was to be decided based upon the intent of the parties. The court concluded that the normal expectations of the parties to a right of first refusal would be that the seller would be in the same position regardless of whether he sold to the holder of the right or to the third party. In the absence of contrary language, that is the probable intent of the parties and so the preemptor could subtract from its price the amount of commission which would have been paid if the sale to the third party had been completed.[150] It acknowledged that the more mechanistic approach taken by some courts[151] would have produced a different result,

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ing the most common type of arrangement today because of the investment of time, effort and, sometimes, advertising money involved in locating prospective buyers. Under it, the seller would be liable for a commission on sale of the property to the preemptor.

147. Where the land is subject to a right of first refusal, it seems that sellers often want the buyer to pay for any broker's commission. This seems to be based on the fact that many brokerage agreements provide that the seller will be liable for the commission even if the land is sold to a third party. Many sellers are unhappy with the prospect of having to pay a commission under those circumstances and so having the seller assume that cost becomes an important point of negotiation. In reality, the seller probably ends up receiving the same amount in the end.

148. Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854 (Fla. 3d Dist. Ct. App. 1970).

149. 23 Mass. App. Ct. 599, 504 N.E.2d 374 (1987).

150. *Id.* at 602-603, 504 N.E.2d at 377 (citing C. Roberts Nattress & Associates v. Cidco, 184 Cal. App. 3d 55, 72-73, 229 Cal. Rptr. 33, 43 (1986)).

151. *Id.* at 603, 504 N.E.2d at 377 (citing Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854 (Fla. 3d Dist. Ct. App. 1970) and Hartmann v. Windsor

but rejected such an approach.

Shower v. Fischer[152] illustrates the operation of a right of first refusal and the features which distinguish it from an ordinary purchase option. The original owners, the Fischers, conveyed part of their land to the Murrays, and gave the purchasers a "first offer of refusal to purchase" the land which they had retained. The Murrays later sold their land, to B-Haven, Inc., including in the sale an assignment of the purchase right.[153] When B-Haven wrote the Showers informing them of its purchase right, the Showers commenced an action to rescind their contract and the Fischers eventually agreed to the rescission. B-Haven, however, continued to insist that it now had the right to purchase the entire Fischer property at the below-appraisal price and the trial court agreed.

The appellate court reasoned that the case turned on whether B-Haven had a right of first refusal or an option. A right of first refusal does not give the right holder the power to force an unwilling seller to sell. It merely gives the holder the right to preempt another buyer if the seller has decided to sell. If B-Haven had a right of first refusal, it was triggered by acceptance of the Showers' offer, but rescission of the Fischer-Shower contract of sale apparently returned the parties to the *status quo ante*, so the event which would have ripened the right into an enforceable option would be missing. There was no willing seller and no prospective buyer for the right holder to preempt.[154] Consequently, if B-Haven had a right of first refusal, it would lose. However, if B-Haven had an option, it could force the landowner to sell because exercising the option would give it an enforceable contract of sale.[155]

Whether this term was an option or a right of first refusal would

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Hotel Co., 132 W. Va. 307, 52 S.E.2d 48 (1949) as examples of the mechanistic approach which requires that the preemptor exactly match the third party's offer.)

152. 47 Wash. App. 720, 737 P.2d 291 (1987). *See also* Green v. First American Bank and Trust, 511 So. 2d 569, (Fla. 4th Dist. Ct. App. 1987). Note that a party could obtain both an option to purchase at a fixed price and a right of first refusal. The rights, unless otherwise specified, would be cumulative. Failing to exercise one would not extinguish the right to exercise the other. *See* Annotation, *Construction and Effect of Options to Purchase at Specified Price and at Price Offered by Third Person, Included in Same Instrument*, 22 A.L.R.4th 1293 (1983).

153. The issue of whether the purchase right could be assigned will be discussed in section V.A. *infra.*

154. Relying on Robroy Land Co., Inc. v. Prather, 95 Wash. 2d 66, 71-72, 622 P.2d 367 (1980). *See also* American Law of Property § 26.64.

155. Relying on Beets v. Tyler, 365 Mo. 895, 290 S.W.2d 76, 81 (1956).

depend on the intent of the parties. The court concluded that the language created a right of first refusal because it referred to a refusal to purchase. That would imply that the purchaser had received another offer first and that would not occur in an option situation.

An agreement could, however, contain both an option and a right of first refusal. This produces a problem where the seller has received an offer for more than the option price. Can the optionee still exercise the option and purchase for the option price or, now that the right of first refusal has been triggered, is he limited to exercising that at the price offered by the third party? Once again, the question is resolved by determining the intent of the parties. The individuality of the agreements has led the Pennsylvania Supreme Court to state that "a decision construing one instrument containing both a fixed price option and a right of first refusal option will not necessarily control a case involving a different instrument."[156] The fact that the fixed price option, if not exercised prior to a sale, would be enforceable against the optionor's successors and by its own terms could be enforced "at any time" led the court to the conclusion that the agreement here gave the optionee the choice of exercising the option or the right of first refusal and, consequently, the right to purchase the property at the lower of the option price or the third party's offer.[157] However, the dissent makes a strong case, based upon the principles of equity and fair dealing, for the rule that in the absence of express provisions, the fixed price term should be terminated when the right of first refusal is triggered by a third party's offer. Otherwise, the option price is an effective cap on the market value of the property.

The question has arisen whether a right of first refusal would be triggered by the offer of one co-owner to buy out the rights of another. Absent specific agreement on the subject, the court would have to determine what the parties to the right had intended. In *Baker v. McCarthy*,[158] the New Hampshire Supreme Court used the language of the deed to determine their probable intent by focusing on the use of the plural term, grantors, referring to the optionors, as the recipients of the offer which would trigger the right. The court concluded that the parties contemplated an offer made to all of the co-owner/optionors from an outside buyer. An outsider purchasing the land would become "a

156. Amoco Oil Co. v. Snyder, 478 A.2d 795, 797 (Pa. 1984), citing Bobali Corporation v. Tamapa Company, 235 Pa. Super. 1, 9, 340 A.2d 485, 490 (1975).
157. *Accord.*, Texaco, Inc. v. Creel, 310 N.C. 695, 314 S.E.2d 506 (1984).
158. 122 N.H. 171, 443 A.2d 138 (1982).

third party to the ownership picture who would adversely affect the plaintiff's rights contemplated by the provisions of her deed."[159] What the optionee had bargained for was the opportunity to avoid having to deal with a stranger in such proximity. Because an offer by a present co-owner would not have the effect of adding any new parties, it was not one of the events intended to trigger her right of first refusal.

Strict compliance with a right of first refusal may be waived. That was asserted in *Coastal Bay Golf Club, Inc. v. Holbein.*[160] Counsel for one of the sellers had called for an indemnification agreement to supplement the buyers' nonconforming exercise of the right and that, claimed the buyers, had waived the requirement of strict compliance. The court pointed out, however, that the sellers were in no position to waive the rights of a third party. This right of first refusal had been triggered by the optionor accepting an offer from another person. That person now had a contract, subject only to the right of first refusal and only he could waive his rights under that contract. Logically, if the right of first refusal had been triggered by the seller only deciding to sell, but not actually accepting another offer, then the seller could intentionally or accidentally waive the optionee's strict compliance with the terms of the right such as exactly matching the prior offer.

D. *Convertible Mortgages*

A mortgage which also gives the mortgagee the option to purchase an interest in the financed development is referred to as a "convertible mortgage" because the mortgagee can convert the mortgage into a contract to purchase an ownership interest.[161] The convertible mortgage

159. *Id.* at 776, 443 A.2d at 141.

160. 231 So. 2d 854 (Fla. 1st Dist. Ct. App. 1970).

161. Some of the literature speaks of the convertible mortgagee being able to convert the mortgage interest directly into an ownership interest. This is slightly misleading because it sounds as if that could take place simply by exercising the convertible feature without the necessity of a conveyance. While an equitable interest in the property would no doubt spring to the mortgagee at that moment, for the mortgagee to get a legal title, and certainly to get a marketable title, would require a conveyance from the mortgagor to the mortgagee. What would obligate the mortgagor to convey would be the contract to convey which the exercised option had become. *See generally* Siegman and Linquanti, *The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction*, 54 U. COLO. L. REV. 295 (1983); Nellis, *Taking a Closer Look: Convertible Mortgages: A Brief Review of the Legal and Drafting Issues*, 8 REAL PROP. LAW REP. 1, CALIFORNIA CONTINUING LEGAL EDUCATION (1985). Note that the term convertible mortgage is also used, on occa-

was designed primarily to protect the lender in a period of rising interest rates and inflation by allowing the lender to recoup whatever profits were lost due to the low interest rate from the profits of the sale of the property. This inflation protection was intended to convince the lender to make the loans that they would otherwise be afraid to make.[162]

In addition, the lender's anticipated future profit may convince it to make the loan for a greater amount and at rates below the current market because the final yield, if the option is exercised, would still be greater than the return on a conventional loan.[163] Lower interest rates mean lower mortgage payments, frequently interest-only during the initial phase, lessening the likelihood that the borrower will develop cash flow problems and increasing the possibilities that the project will be a success.

The option is also used to restructure a financing transaction to maximize the borrower's tax benefits[164] while minimizing the lender's risks of liability in contract or tort. The lender may maximize the benefits of participating in the profits of a venture, but avoid the risks of the venture.[165] Rather than utilize an ordinary loan, secured by a mortgage or other debt instrument, or have the lender acquire an interest in the development, becoming a co-venturer, a partner or an equity participant, one could utilize a mortgage combined with an option to purchase an interest, possibly the entire fee simple, at a designated point in the future. At that time the lender should know if the venture is going to be profitable.

This leaves the developer with the legal title in the property. The

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sion, for another purpose, to describe the type of adjustable rate mortgage which allows the mortgagor to "convert" to a fixed rate according to specified terms.

162. The convertible mortgage "was designed principally as a tax efficient inflation hedge for American pension fund investors . . . which evolved in response to an unprecedented period of escalating inflation and interest rates." Norstrand, *The Convertible Mortgage and the Equity of Redemption*, 26 BOSTON B.J. 25, 26 (Sept, 1982). Note, however, that some types of lenders are limited in their ability to enter convertible mortgages. For illustrations *see Legal Restrictions on Equity Participation Financings*, 20 REAL PROP. PROB. & TR. L. J. 1139 (1985); Siegman and Linquanti, *supra* note 161, at 375-392.

163. *See* Maller, *Financing Ideas: Legal Concerns in Convertible Mortgage Transactions*, 13 REAL ESTATE L.J. 277 (1984); Oharenko, *Convertible Mortgages Gain Big League Attention*, 44 MORTGAGE BANKING 20 (July, 1984).

164. *See* Wyndelts and Parker, *Using Options to Enhance Tax Benefits for Real Estate: An Overlooked Tool*, 2 J. TAX'N INVESTMENTS 213-225 (1985).

165. Siegman and Linquanti, *supra* note 161 at 299-321 (regarding the convertible mortgage holder as a partner or creditor of the mortgagor.)

lender has neither legal nor equitable title because equitable conversion does not apply to vest an equitable interest in him until the option is exercised and the accepted offer becomes a contract of sale.[166] The developer, on the other hand, would benefit from the tax treatment of the arrangement, prior to the exercise of the option, as a loan which leaves it the owner in fee of depreciable property.[167] Also, the cash to the borrower is in the form of a loan which is not taxed as income from the sale of an interest.[168] If the lender is not subject to income taxation, for example, if it is a pension fund or a governmental unit, it would not be harmed by this characterization of the payments as mortgage payments, usually all interest.

The lender would benefit from the flexibility of deciding at a later time if it prefers to ultimately be treated as a lender or an owner. Until it decides, the experienced management of the developer, having the incentives of ownership, remains in control. Meanwhile, the lender has the ideal position to observe the performance of the property to determine if ownership would be worthwhile. Also, the option is a valuable asset which could sell or hypothecate to third.[169] Until the option is exercised, the lender is guaranteed the income of the regular mortgage payments.[170]

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166. *See supra* note 26.

167. Regarding the benefits of convertible mortgage financing, *see* Oharenko, *supra* note 163 at 20; Nellis, *supra* note 161, at 8, which states that the tax advantages to the borrower/optionor include that capital gains tax is avoided until the conversion occurs, that the borrower/optionor used the convertible mortgage device to hold the property long enough to qualify for the capital gains holding period, and that dealer status may be avoided by staggering the sales, thus avoiding ordinary income treatment.

168. Preble and Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 Real Prop. Prob and Tr. J. 821, 822 (Fall 1985). However, the fee paid to the owner/borrower for the option is another matter. It is taxable income. Note that convertible mortgages are often grouped in discussion with shared appreciation or equity participation mortgages. In the ordinary equity participation or shared appreciation mortgage, the mortgagee is a participant from the first day. The convertible feature allows the mortgagee to delay deciding until some point after the execution of the mortgage whether to become a participant in the income and growth of the venture. A mortgage may combine both features, *e.g.*, a participation from the first day and the option for additional participation in the future.

169. Ellis and Abramowitz, *Contracts as Commodities: Issues and Approaches in Regard to Commercial Real Estate "Earnest Money" and "Option" Contracts—A Texas Lawyer's Perspective*, 16 St. Mary's L.J. 541 (1985).

170. Oharenko, *supra* note 163, at 22, which points out, "a typical convertible mortgage is structured as a participating loan with a competitive coupon rate that in-

Frequently it is the borrower who seeks this method of financing. Borrowers may prefer the convertible mortgage over other forms of equity participation financing because they retain control over the development as well as the tax benefits of the interest and depreciation deductions.[171] The optionor has a built-in market for the sale of the successful project, meaning a sale without the cost of brokers' fees, possibly 10%, and the delay involved in finding a buyer.[172] However, a negative aspect for the borrower is the lack of control over the exercise of the option which the lender will time to maximize its profits, possibly to the detriment of the borrower.[173]

Convertible mortgages are not without their problems. They are intricate transactions and that may result in greatly increased legal fees and mortgage underwriting fees limiting their availability to large deals involving experienced developers.[174] There is also the danger that the option may not be exercisable if the project begins to fail, the very time when the lender may decide to take over the project as quickly as possible. A mortgagee who felt that the option protected it from possible losses caused by the borrower's default would be in for a surprise. Although the lender might want to exercise the option and take over the project if the borrower got into financial trouble, it may be prohibited from doing so because the option may be held invalid as an attempt to clog the defaulting borrower's equity of redemption under the mortgage.[175] The effect, should the borrower default, would be to require

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cludes additional interest payments in the form of cash flow participation."

171. *Id.*

172. *See Id.*; 8 REAL PROP. LAW REP., (CALIFORNIA CONTINUING LEGAL EDUCATION 1985);

173. Oharenko, *supra* note 163.

174. *Id.* at 22.

175. Equity would allow a borrower who had defaulted to redeem his property from the mortgagee by tendering the whole amount owed. That equitable right to redeem, the equity of redemption, continued until so much time had elapsed that it would no longer be equitable to allow redemption. Because the outstanding equity of redemption would make the property unmarketable, equity would allow the lender to seek a termination date from the court at which point the equity of redemption would be foreclosed. Agreements ousting the equity court of its jurisdiction to grant redemption were regarded with hostility and held invalid if they "clogged" the equity of redemption. *See* NELSON AND WHITMAN, REAL ESTATE FINANCE LAW §§ 3.1-3.2 (2d ed. 1985).

A mortgage in which the mortgagee has the option to purchase the mortgaged property is not necessarily invalid as a clog on the equity of redemption. The decision would turn on whether the parties intended to defeat the equity of redemption and

the lender to foreclose on the mortgage rather than exercising the option. Unless the mortgage provides otherwise, that would probably prevent the mortgagee's taking possession of the property until after foreclosure.[176] Even if the mortgagee could take possession, it would be in a precarious position, owing a fiduciary duty to the borrower, compared to its position if it had been able to exercise the option and become the owner.[177]

Even a borrower who is not in default may resist the lender's exercising the option by claiming it is a disguised self-help foreclosure and threaten the lender with protracted litigation. In addition, in those states with statutory redemption periods following foreclosure, the lender's period of danger would be extended by a borrower asserting a right to redeem the property from the optionee. This problem may cloud the title acquired by exercising the option, making the property unmarketable. Consequently, the lender should avoid the convertible mortgage format unless certain that the project will succeed.[178]

The acceptance of this method of financing may lead to pressure upon state legislatures to eliminate the clogging problem. Legislation is already beginning to appear. California has adopted a statute which prevents an option from being held invalid as an impairment of the equity of redemption if the right to exercise the option is not based on the default on the mortgage and if the mortgage is for other than a one to four unit residential property.[179] New York has adopted a statute

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whether the lender used his superior bargaining position unfairly to acquire the right. *See* Smith v. Smith, 82 N.H. 399, 135 A. 25 (1926); Barr v. Granahan, 255 Wis. 192, 38 N.W.2d 705 (1949); MacArthur v. North Palm Beach Utilities, Inc., 202 So. 2d 181 (Fla. 1967); Humble Oil & Refining Co. v. Doerr, 123 N.J. Super. 530, 303 A.2d 898 (1973). *See also* Cooper-Hill and Slama, *The Convertible Mortgage: Can It Be Separated from the Clogging Rule?*, 27 S. TEX. L. J. 407 (1986).

176. In most jurisdictions the mortgagee has only a lien, or some variation of a lien, on the mortgaged property. Only in title theory states would the mortgagee have the right to take possession upon default because in those states the mortgagor's right to possession was granted contractually by the mortgage. *See* G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW §§ 4.1-4.3 (2d ed. 1985).

177. *Id.* at §§ 4.2-4.3.

178. Even this might not be enough to protect a pension fund from the charge that it had violated the "prudent man" rule of ERISA by investing in the convertible mortgage. Strawn, *The Convertible Mortgage - Is it Really Convertible?*, PENSION WORLD February, 1982 at 37.

179. CAL. CIVIL CODE § 2906 (Deering 1986). This was sponsored by the California Land Title Association and "obviates any concern about the 'clogging rule' for purposes of the use of convertible mortgages in commercial transactions in California."

which prevents the option from being held invalid for loans of at least two and a half million dollars if the power to exercise the option is not dependent on the mortgagor's default.[180]

Combining an option with a loan may produce another complication. Granting an option to purchase to the lender may be held to constitute additional interest charged for the loan.[181] The effect may be to produce a usurious interest rate.[182]

> If the option is given in partial consideration for the loan, the value of the option-presumably its present discounted value-would in most states be treated as additional interest. In most cases, the option value could be spread over the lesser of the term of the loan or the option term, although in some states the option might be considered analogous to a bonus and the option value deducted from the loan principal in order to measure the interest that can be lawfully received.[183]

Whether the state still limits the amount of interest which may be charged and the factors which would lead to the conclusion that the loan is usurious should be carefully examined before drafting or executing such a loan. In many states usury may produce both criminal as

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8 REAL PROP. LAW REP. 1, 4 (CALIFORNIA LEGAL EDUCATION 1985).

180. State of New York, 1985-86 Regular Session, S. 2710, A 3564, amending General Obligations Law by adding section 5-334.

181. Roegge, Talbot and Zinman, *Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579, 624 (1971), points out the classic example of what may constitute interest by the case of Vilas v. McBride, 17 N.Y.S. 171 (1891), *aff'd*, 136 N.Y. 634, 32 N.E. 1014 (1892), holding that a mortgage loan was at a usurious rate because the value of manure to be received by the mortgagee was treated as additional interest.

182. *See, e.g.* Regents of the University of California v. Sup. Ct. of Alameda Cty., 17 Cal. 3d 533, 137 Cal. Rptr. 228, 551 P.2d 844 (1976), involving an option to purchase an interest in oil royalties given in partial exchange for an apparently below interest loan. *See* Siegman and Linquanti, *The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction*, 54 U. COLO. L. REV. 295, 326-338 (1983). *See also* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. TR. L. J. 315 (1969); Respress, *Equity Participation in Real Estate Finance*, 7 N.C. CENT. L.J. 387 (1976); Cooke, *Equity Participation in Texas: A Lender's Dream or a Usurious Nightmare*, 34 SW. L.J. (1980).

183. Nellis, *Taking a Closer Look: Convertible Mortgages: A Brief Review of the Legal and Drafting Issues*, 8 REAL PROP. LAW REP. 1, 4 (Jan. 1985), citing Cochran v. American Sav. & Loan Ass'n, 568 S.W.2d 672 (Tex. Civ. App. 1978), *modified and aff'd*, 568 S.W.2d 849 (Tex. 1979).

well as civil liability.[184] Moreover, avoiding the usury and clogging problems does not immunize from the claim that the option is unenforceable because it is unconscionable.[185]

Unfortunately, trying to solve the usury and clogging problems may cause undesirable side effects.[186] As one commentator pointed out:

> The concerns about claims of usury and clogging of the equity of redemption can be obviated if the transaction is structured as a deferred sale to the lender of an equity position in the underlying security. However, once bankruptcy and federal income tax considerations are taken into account, such a characterization would undercut some of the principal reasons for choosing the convertible mortgage format in the first place.[187]

If the borrower were to go into bankruptcy, the estate could reject an executory contract, including an option.[188] If the drafter structured the entire transaction to look like a contract for a deferred sale to avoid the clogging and usury problems discussed above, that would certainly be an executory contract which could be rejected and that structure might mean that the lender would lose its status as a secured creditor and the protection such status provides.[189] Even if the lender's secured creditor status is not disturbed, its priority is not necessarily secure because the court can apply the doctrine of equitable subordination to

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184. For example, in Florida, interest may not exceed 18% on loans not exceeding $500,000. FLA. STAT. § 687.03 (1985). The civil penalty is the forfeiture of interest not paid and double the interest actually paid. FLA. STAT. § 687.04 (1985). Willfully and knowingly charging interest over 25% up to 45% is a second degree misdemeanor and charging over 45% is a third degree felony; and, in addition, the principal as well as the interest on such loans cannot be enforced in the state's courts. FLA. STAT. § 687.071 (1985).

185. *See* Goldstein, *Unconscionability: Some Reconsiderations with Particular Reference to New-Type Mortgage Transactions*, 17 REAL PROP. PROB. & TR. L.J. 412 (1982); Kane, *The Mortgagee's Option to Purchase Mortgaged Property*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S, 123 (A.B.A. REAL PROP. PROB. & TR. L. Sect. 1981).

186. Maller, *Financing Ideas: Legal Concerns in Convertible Mortgage Transactions*, 13 REAL ESTATE L. J. 277, 284 (1984).

187. *Id.* at 281.

188. *See* § VI.G. *infra* for a general discussion of the Bankruptcy Code's application to purchase options. A discussion of the Code's treatment of mortgages, and the problems that may arise from a pre-bankruptcy foreclosure of the mortgage, would be beyond the scope of this article.

189. *See* Maller, *supra* note 186, at 281.

subordinate all or part of the claim or interest.[190] Equally troubling to the lender, is the buyer's exercising the option as much as a year before the optionor's bankruptcy could possibly be set aside as voidable preference or even a fraudulent transfer.[191]

The final concern is the loss of the tax benefits which the convertible mortgage structure was intended to provide. The I.R.S. may assert that the loan is really a capital contribution from a partner or co-venturer and that the true nature of the transaction is a partnership between the lender and borrower, creating income tax.[192] Although drafting strategies have been suggested to minimize the risks discussed above,[193] under the current law, safely structuring a convertible mortgage is a difficult and risky task[194] justified only in a large, secure and potentially very profitable project.

V. Problems with Purchase Options

A. *Transfer*

The rights of the optionee may be transferred and the obligations of the optionor may bind those to whom the optioned land has been transferred. The question of whether that has happened is primarily a question of the intent of the parties to the option. However, the prob-

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190. Bankruptcy Code of 1978, 11 U.S.C. §501(c). *See* Siegman and Linquanti, *The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction*, 54 U. COLO. L. REV. 295, 321-326 (1983). *See also* Seneker and Lewis, *Selected Bankruptcy Aspects of Real Estate Partnerships and Hybrid Debt-Equity Arrangements*, Chapter X in REAL ESTATE BANKRUPTCIES AND WORKOUTS: A PRACTICAL PROSPECTIVE, (ABA Section of Real Property, Probate and Trust Law 1983).

191. These are discussed briefly in § V.E. *infra*.

192. For example, the transaction may be recharacterized as a partnership rather than as a mortgage. *See* Steuben, *The Convertible, Participating Mortgage; Federal Income Tax Considerations*, 54 U. COLO. L. REV. 237 (1983). In addition, if the mortgage interest rate is significantly below market rate in partial consideration of the option, the I.R.S. might attempt to impute and levy tax upon a higher interest rate.

193. Siegman and Linquanti, *supra* note 190, at 358-370.

194. *See* Kane, *A Case for Convertible Mortgages*, reprinted from the New York Law Journal (May 13, 1985) in *Creative Real Estate Financing 1986*, PRACTICING LAW INSTITUTE, 279 Real Estate Law and Practice Course Handbook Series (1986), advocating that state legislatures should act to eliminate the obstacles to lenders utilizing convertible mortgage financing. *See also The Convertible Mortgage - Is it really convertible?* PENSION WORLD 37 (February, 1982), suggesting shared appreciation mortgages as a preferable financing vehicle.

lem usually faced in litigation is how to interpret the option where the parties failed to express their intent. Moreover, for an option to bind the successors to the land, it must meet the requirements, in addition to the parties intent, of any covenant whose burden runs with the land.[195]

Ordinarily, an optionee would be unlikely to bargain for a right which could be defeated by the sale to another and so the option should be presumed binding on the optionor's successors unless otherwise agreed. Likewise, a right of first refusal would be binding against a transferee unless the right had been waived, extinguished by the failure to exercise it after it had been triggered by an offer, or extinguished by an involuntary sale. The parties could even agree that a right of first refusal would be enforceable against the transferee whose offer would have triggered the preemptive right.[196]

Absent agreement to the contrary, land subject to an option is freely alienable until the option has been exercised.[197] While an attempt to absolutely prohibit the transfer of the property would be invalid as a restraint on alienation,[198] a reasonable prohibition would be upheld. A very common example is the condominium rules which require that prospective purchasers be approved by the association and, in the event of disapproval, the association has the right for itself or for another purchaser it has proffered to preempt the offeror. These have been upheld if not applied unreasonably or arbitrarily.[199]

Where the optionor attempts to convey the property in violation of the optionee's rights, the court of equity may enjoin the sale, order the optionor's contract with the third party rescinded, and decree specific performance for the optionee.[200] If the optionor has already transferred

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195. *See* Stoebuck, *Running Covenants, An Analytical Primer*, 52 WASH. L. REV. 861 (1977).

196. *See, e.g.*, Texaco, Inc. v. Creel, 310 N.C. 695, 314 S.E.2d 506 (1984); Robbinson v. Central Properties, Inc., 468 So. 2d 986 (Fla. 1985), although the survivorship of the right of first refusal was not a contested issue in either case.

197. *See* Annotation, *Option To Purchase Real Property As Affected By Optionor's Receipt Of Offer For, Or Sale Of, Larger Tract Which Includes The Optioned Parcel*, 34 A.L.R.4th 1217 (1984).

198. *See* the discussion of the Rule Against Restraints on Alienation in § VI.F. *supra.*

199. Lyons v. King, 397 So. 2d 964 (Fla. 4th Dist. Ct. App. 1981). *See* Annotation, *Validity, Construction, and Application of Statutes, or of Condominium Association's Bylaws or Regulations, Restricting Sale, Transfer, or Lease of Condominium Units*, 17 A.L.R.4th 1247 (1982).

200. S.B.R.'s Restaurant, Ltd. v. Towey, 515 N.Y.S.2d 573 (App. Div. 1987), where the right involved was a right of first refusal included in a lease.

the property, the optionee could obtain specific performance against the transferee, forcing him to convey the property to the optionee.[201] The optionee may also be able to obtain damages from the breaching optionor[202] and against a third party who has tortiously interfered with his contract rights under the option.[203]

Where the transferee does not have notice of the option or right of first refusal and has paid value,[204] he may take title free of the burden so it may not be asserted against him.[205] An example is *Bonded Investment and Realty Company v. Waksman.*[206] The original buyer had taken title subject to the developer's unrecorded option to repurchase if construction on a house was not commenced within three years. The buyers from the original purchaser took by a contract which recited that "Buyer has been informed that construction must be commenced by May 1, 1981" but there was nothing in the records about the option nor were they ever informed about it. The developer subsequently sought specific performance of the reconveyance option. The court held that absent notice the buyers were not bound by the option and the recital did not put them on inquiry, that is, they had no duty to inquire further about it.

The usual, but not the only, manner of giving notice to potential subsequent buyers is by recording the option in the appropriate public records.[207] However, under most recording schemes, the prospective

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201. *See* § VI. B. *infra.*

202. *See* Annotation, *Tenant's Right to Damages for Landlord's Breach of Tenant's Option to Purchase*, 17 A.L.R.3d 976 (1968).

203. Young v. Pottinger, 340 So. 2d 518 (Fla. 2d Dist. Ct. App. 1976). *But see* Gross v. Lowder Realty Better Homes and Gardens, 494 So. 2d 590 (Ala. 1986).

204. That is, where he is a good faith or bona fide purchaser for value.

205. *See* Annotation, *What Constitutes Notice To Subsequent Purchaser of Real Property Of Option To Purchase Contained In Unrecorded Lease*, 17 A.L.R.2d 331 (1951).

Even though a contract may be valid, it may be unrecordable if not executed in accordance with the state's recording statute. *See, e.g.* FLA. STAT. § 696.01 (1985), which prohibits recording any contract to sell land in Florida unless the contract is acknowledged in the same manner as a deed. Absent recording, the contract of sale is ineffective against a good faith purchaser for valuable consideration without notice. FLA. STAT. § 695.01 (1985).

206. 437 So. 2d 162 (Fla. 2d Dist. Ct. App. 1983).

207. *See generally* R. BOYER, SURVEY OF THE LAW OF PROPERTY Chapter XXIII (2d ed. 1981); J. CRIBBET, PRINCIPLES OF THE LAW OF PROPERTY ch. 6, § 3 (2d ed. 1975); R. CUNNINGHAM, STOEBUCK AND WHITMAN, THE LAW OF PROPERTY §§ 11.9-11.10 (1984).

purchaser may be put on notice by other means. Being informed directly by the optionor, the optionee or someone else would be sufficient because it is actual notice.[208] Similarly, if someone other than the seller is in possession, such as a lessee, a prospective purchaser is put on notice that the possessor may have some rights to the property and the prospective purchaser has a duty to inquire to discover the extent of those rights. The purchaser would be charged with notice of those interests which he would have discovered if he had inquired.[209] If the lessee also has an option or a right of first refusal, the transferee who had inquiry notice of it would take subject to it.[210]

An option may give the optionee an independent right or may include that right as part of another transaction or conveyance. An independent option can be assigned like any other contract right, but it is presumed that the parties intended the option to be nontransferable.[211] If the option is included in a conveyance, it can be assigned separately from the conveyance only if it was intended to be personal. Ordinarily, absent agreement to the contrary, the presumption exists that a purchase option or right of first refusal, except if appearing in a lease,[212] lasts only during the lives of the parties.[213]

Although the presumption against assignability does not apply to a lease-option, it is presumed that such options cannot be assigned separately from the leasehold.[214] Absent a manifestation that the parties intended that the lessee's purchase option would be personal to him, his

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208. Only in a jurisdiction with a pure race recording statute would actual notice of an unrecorded option be insufficient to make the option effective against the subsequent purchaser. *See* POWELL ON REAL PROPERTY § 905(1)(a).

209. *See Id.* at § 905(2).

210. Denco, Inc. v. Belk, 97 So. 2d 261 (Fla. 1957).

211. Shower v. Fischer, 47 Wash. App. 720, 737 P.2d 291 (1987), relying on 6 AMERICAN LAW OF PROPERTY § 26.67, at 984 (1977 Supp.). *But see* Adams v. Stoffer, 69 So. 2d 884 (Fla. 1954).

212. Randolph v. Koury Corp., 312 S.E.2d 759 (W. Va. 1984). *See* Annotation, *Right of Assignee or Sublessee to Enforce Option Contained in Lease for Purchase of Property*, 45 A.L.R.2d 1034 (1956).

213. Shower v. Fischer, 47 Wash. App. 720, 737 P.2d 291 (1987), *citing*, Lantis v. Cook, 342 Mich. 347, 69 N.W.2d 849 (1955); Kerschner v. Hulburt, 277 S.W.2d 619 (Mo. 1955); Roemhild v. Jones, 239 F.2d 492 (8th Cir. 1957); and 6 AMERICAN LAW OF PROPERTY § 26.67, at 1984 (1977 Supp.).

214. Gilbert v. Van Kleeck, 284 A.D. 611, 132 N.Y.S.2d 580 (1954). *See* Annotation, *Who May Enforce Option Contained In Lease For Purchase Of Property*, 38 A.L.R. 1162 (1965); Annotation, *Right Of Assignee Or Sublessee To Enforce Option Contained In Lease For Purchase Of Property*, 45 A.L.R.2d 1034 (1956).

assignment[215] of his lease would deprive him of the ability to exercise the option.[216] Only the assignee could exercise it. A sublease, in contrast to an assignment,[217] would not transfer the option to the subtenant. It leaves the sublessor, not the subtenant, with the right to exercise the option.[218] Similarly, where buyers under an installment contract assigned all their rights under the contract and to the land, only the assignee would be able to exercise the right of first refusal contained in the contract.[219]

The optionor must be notified of the assignment before the option can be exercised by the assignee.[220] The optionor cannot refuse to perform the assigned option unless the assignment is void; that the option would be voidable would not excuse his performance.[221] However, absent estoppel, an assignee stands in no better position than the original optionee.[222]

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215. "Assignment of a lease" is a term of art used to signify that the assignor has transferred his entire leasehold to the assignee. The original tenant who has assigned no longer has any interest in the land. Consequently, any rights which flow from his prior estate in the land, *e.g.*, the benefits of any covenant which runs with the land, would pass with the leasehold to the assignee.

216. L & M Corporation v. Loader, 688 P.2d 448 (Utah 1984); Moore & McCaleb, Inc. v. Gaines, 489 So. 2d 491 (Miss. 1986).

217. A "sublease" means that the tenant has conveyed, or sub-leased, part but not all of his interest to a subtenant, in contrast to an assignment which would involve a transfer of all of the tenant's estate. Because the subtenant does not acquire the entire interest of his grantor, the original tenant, becomes his landlord. The original tenant because he still has a leasehold interest, is in a contractual and tenurial relationship with the landowner who is his landlord. The subtenant has no relationship with the landowner because his landlord is the original tenant.

218. *See* Annotation, *Right Of Assignee Or Sublessee To Enforce Option Contained In Lease For Purchase Of Property*, 45 A.L.R.2d 1034 (1956); Annotation, *Who May Enforce Option Contained In Lease For Purchase Of Property*, 38 A.L.R. 1162 (1925).

219. *See, e.g.*, Barnhart v. McKinney, 235 Kan. 511, 682 P.2d 112 (1984), but note that the assignees there also obtained the seller's consent to the assignment and by her later conduct the seller acknowledged the validity of the assignment.

220. Melton v. Michigan Trust Co., 93 Fla. 645, 111 So. 513 (1927).

221. Randolph v. Koury Corporation, 312 S.E.2d 759 (W. Va. 1984).

222. Goodman v. Goodman, 290 So. 2d 552 (Fla. 1st Dist. Ct. App. 1973) (an option which failed to include material terms had produced no meeting of the minds and could not be enforced by the optionee's assignee as that would not produce a contract).

B. *The Rules Against Perpetuities and Restraints on Alienation*

Historically the Rule Against Perpetuities was considered applicable to purchase options[223] and to preemptive rights.[224] As viewed from the time it was executed, an option which could possibly still tie up the land after the passing of the lives in being plus twenty-one years would be void.[225] For example, an option to purchase land within 120 days of the city's acquisition of land for two new highways was held to violate the rule. The optionee was a corporate entity and no reference had been made in the option to any life or lives in being, so the measuring period was 21 years. There existed the clear possibility that the exercise of the option might occur after the prescribed period. Consequently, the option was void *ab initio*.[226]

The theory is that an option, if exercised, would give the optionee an equitable estate. Before it is exercised, the option is similar to a future equitable estate which could spring out of the owner at an indefinite time in the future, a mere possibility, contingent upon the grantee's whim, which might vest at a remote time in the future. This would seem to be exactly the type of contingent interest, *i.e.*, a contin-

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223. Kershner v. Hurlburt, 277 S.W.2d 619 (Mo. 1955). *See* Powell, ON REAL PROPERTY 771; Berg, *Long-Term Options and the Rule Against Perpetuities*, 37 CAL. L. REV. (Part I) 1-37, (Part II) 235-268, (Part III) 419-454 (1949); Langeluttig, *Options To Purchase And The Rule Against Perpetuities*, 17 VA. L. REV. 461 (1931); Annotation, *Independent Option To Purchase Real Estate As Violating Rule Against Perpetuities Or Restraints On Alienation*, 66 A.L.R.3d 1294 (1975). *See also* dicta in Inglehart v. Phillips, 383 So. 2d 610, 614 (Fla. 1980).

But see Warren v. City of Leesburg, 203 So. 2d 522, 526 (Fla. 2d Dist. Ct. App. 1967), where the court stated in dicta that: "the weight of authority holds that a mere option to purchase land (or repurchase land) does not vest the holder . . . with any interest. . . . Such is strictly a contractual right, not a property right, while the rule against perpetuities is a rule of property rather than a rule of contract."

224. *See* Annotation, *Pre-emptive Rights To Realty As Violation Of Rule Against Perpetuities or Rule Concerning Restraints On Alienation*, 40 A.L.R.3d 920 (1971); Annotation, *Independent Option To Purchase Real Estate As Violating Rule Against Perpetuities Or Restraints On Alienation*, 66 A.L.R.3d 1294 (1975).

225. Barnhart v. McKinney, 235 Kan. 511, 682 P.2d 112 (1984).

226. United Virginia Bank/Citizens & Marine v. Union Oil Company of California, 214 Va. 48, 197 S.E.2d 174, 66 A.L.R.3d 1286 (1973), which also held that the doctrine of *cy pres* would not be available to avoid the application of the Rule Against Perpetuities. *See also* Certified Corp., v. GTE Products Corporation, 392 Mass. 821, 467 N.E.2d 1336 (1984), where an in gross twenty five year option to purchase met a similar fate.

gent remainder or a shifting or springing interest,[227] which the Rule Against Perpetuities was intended to limit. But the rule did not apply to future interests retained by the grantor, for example, a possibility of reverter, the right, of re-entry or a reversion.[228] The logical application of this exception should result in the rule not applying to options retained by the grantor, but courts have not reached that conclusion.[229]

Application of the rule has been frequently avoided, revealing a judicial distaste for its effects. Whenever possible, it seems courts interpret the option so as to uphold the validity of the option.[230] For example, the Kansas Supreme Court, despite the fact that the option specified that it bound the heirs, executors, administrators and assigns of the respective parties, construed an option to repurchase in the event that the buyers ever decided to sell as personal to the optionees.[231] It could not last for more than their lives and so could not remain contingent beyond the proscribed lives in being plus twenty one years.[232] In an-

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227. *See* MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY, Ch. 9, § 10 (1962); Bergin and Haskell, Preface to Estates in Land and Future Interests, Ch. 8 (1984); SIMES, LAW OF FUTURE INTERESTS, Part V (2d ed., 1966).

228. *See, e.g.*, Emerson v. King, 118 N.H. 684, 394 A.2d 51 (1978) where the court characterized the grantee's title as being a fee simple defeasible subject to the purchase option. The court did not discuss whether the Rule Against Perpetuities would be inapplicable, concluding instead that the requirements of the Rule had been satisfied because the option must vest in time.

229. *See, e.g.*, Broach v. City of Hampton, 283 Ark. 496, 677 S.W.2d 851 (1984).

230. *See, e.g.*, Crawford v. Deshotels, 359 So. 2d 118 (La. 1978), narrowly construing the statutory prohibition against options which do not contain express time limitations as not applying to rights of first refusal. *See also* Brauer v. Hobbs, 151 Mich. App. 769, 391 N.W.2d 482 (1986), interpreting the Rule to require that in the absence of a specific time limit courts should construe the option or right of first refusal to be for a reasonable time rather than holding it to be void.

Conversely, the policy behind the Rule indicates that courts should narrowly construe options and preemptive rights. *See* RESTATEMENT, SECOND, PROPERTY § 4.4, comments c and d and Introductory Note to Part II; 6 AMERICAN LAW OF PROPERTY § 26.66.

231. Barnhart v. McKinney, 235 Kan. 511, 682 P.2d 112 (1984). *See also* Kershner v. Hurlburt, 277 S.W.2d 619, 623 (Mo. 1955), where a similar construction was reached relying on the facts that the contract did not specify that heirs and assigns would be bound by it, nor include any indication that the parties intended that it extend beyond their respective lives. *See also* Layne v. Henderson, 232 Va. 332, 351 S.E.2d 18 (1986), interpreting a mutual buy-out option to the survivor or survivors of three co-purchasers to be exercisable only by one of the original parties during his lifetime.

232. Similar logic was used in Broach v. City of Hampton, 283 Ark. 496, 677

other example, the Georgia Supreme Court upheld an option which extended ninety days beyond the death of the survivor of the two tenants, and provided that the ninety days did not begin to run until the optionee was notified of the death. The court held that a reasonable time was to be implied which could not exceed twenty one years.[233]

The policy behind the Rule Against Perpetuities may be frustrated by the complexity in its application. The value of options to the real estate business may not outweigh the policy behind the Rule, but the interests can be harmonized by simple time limits which would not invalidate the option *ab initio*. Some state legislatures have responded. One has exempted options and rights of first refusal from the Rule's coverage, but simultaneously placed a forty year limit on the duration of such rights in gross[234] except where other specific exceptions have been found justified, for example, reasonable restrictions on the transfer of a condominium unit by the condominium association's rights of first refusal.[235] Another state has taken the approach of limiting the duration of options, except for repurchase options and options contained in leases,[236] to twenty years, but making those without an express duration unenforceable after two years.[237] Furthermore, to prevent recorded, but unexercised, options from clouding the titles, it provides that a recorded option no longer provides notice of the optionee's rights if one year has elapsed from the point of expiration, renewal or extension without any notice being recorded that the option

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S.W.2d 851 (1984), to conclude that the city's option to repurchase, if it needed the land for the sewer system, would extend only for the lives of the optionees.

233. Young v. Cass, 255 Ga. 508, 340 S.E.2d 185, 186 (1986).

234. FLA. STAT. § 689.22(3)(a)7 (1985). "Options to purchase in gross or in a lease or preemptive rights in the nature of a right of first refusal, but no option in gross is valid for more than 40 years from the date of its creation." However, it is appropriate to note that there are options which are neither in gross nor in a lease and, consequently, not within the specific language of this statute. In addition, the 40 year limit only applies to options in gross. Therefore, options running with the land apparently may have an unlimited duration. It would also appear that rights of first refusal could have an unlimited duration under this statute. However, a right of first refusal is an option which is subject to a condition precedent. Consequently, the exception for options should include rights of first refusal because they are a sub-category of options.

235. FLA. STAT. § 718.104(5) (1985).

236. ALA. CODE § 35-4-76(a) (1975). The limitation further requires that the option contained in the lease must be exercisable not later than the end of the term of the lease to qualify for the exception.

237. ALA. CODE § 35-4-76(a) (1975).

has been exercised[238] unless the optionee is in possession of the land.[239]

Other societal needs may outweigh the policy behind the Rule where the parties are commercial or governmental entities. Noting that the lack of a human measuring life reduces the applicable period to twenty-one years, the New York Court of Appeals pointed out that, the Rule, which is aimed at remote vesting, is really the wrong rule to test the validity of preemptive rights of unlimited duration because it is too inflexible. Such options impose only a minor impediment to free transferability of land while preventing legitimate transactions. Applying the Rule Against Perpetuities to them would undermine its purpose, the encouragement of the use and development of property.[240] The appropriate test for validity should be the Rule Against Unreasonable Restraints on Alienation.

The Rule Against Restraints on Alienation, however, does have an inflexible aspect in that it prohibits direct restraints which disable the landowner from conveying or which provide for a forfeiture in the event of conveyance,[241] but its flexible aspect is illustrated by *Inglehart v. Philips*,[242] a case which came to the Florida Supreme Court on a certified question from the United States Court of Appeals for the Fifth Circuit. It asked whether a seller's right of first refusal for an unlimited time, at a purchase price determined not by the preempted offer but fixed at the buyer's original cost plus the cost of improvements, and for no other purpose than consideration had been given was void or unenforceable.[243] The case was decided based upon the common law Rule Against Restraints on Alienation, never reaching the perpetuities question.[244]

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238. ALA. CODE § 35-4-76(b) (1975).

239. ALA. CODE § 35-4-76(c) (1975).

240. Metropolitan Transportation Authority v. Bruken Realty Corporation, 67 N.Y.2d 156, 492 N.E.2d 379, 384 (1986), holding that the rule against remote vesting, *e.g.*, the Rule Against Perpetuities, would not be applicable where the parties were a State authority and a national transportation corporation.

241. Broach v. City of Hampton, 283 Ark. 496, 677 S.W.2d 851, 855 (1984).

242. Inglehart v. Phillips, 383 So. 2d 610, 611 (Fla. 1980).

243. *See* Phillips v. Inglehart, 626 F.2d 393 (5th Cir. 1980), where the United States Court of Appeals applied the answers provided by the Florida Supreme Court.

244. Inglehart v. Phillips, 383 So. 2d at 617. The Rule Against Restraints on Alienation has consistently been applied to rights of first refusal as well as to purchase options. *See, e.g.*, Colen v. Patterson, 436 So. 2d 182 (Fla. 2d Dist. Ct. App. 1983); *See also* Annotation, *Pre-emptive Rights To Realty As Violation Of Rule Against Perpetuities or Rule Concerning Restraints On Alienation*, 40 A.L.R.3d 920 (1971); Annotation, *Independent Option To Purchase Real Estate As Violating Rule Against*

The court pointed out that the distinction between the rules is that the Rule Against Restraints on Alienation is really a rule against unreasonable restraints,[245] the focus being on duration, while the Rule Against Perpetuities is concerned with the remoteness of interests vesting. Consequently, in applying the former, "[t]he test which should be applied with respect to restraints on alienation is the test of reasonableness. . .[it] depends upon its long-term effect on the improvement and marketability of property. Once that effect is determined, common sense should dictate whether it is reasonable or unreasonable."[246]

Generally an option is considered reasonable ". . . if the option price is at market or appraised value, irrespective of the duration of the option."[247] If not in a lease, an option of unlimited duration at a fixed price is an unreasonable restraint[248] because it would discourage the owner from improving the property. In contrast, such an option held by a lessee would encourage him to improve the property. Because that option would discourage improvements, it was held invalid as an unreasonable restraint on alienation.[249]

The Missouri Supreme Court applied the Rule Against Restraint on Alienation in a similar fashion in dealing with a provision which gave the seller the right to repurchase the property at a fixed price if the buyers ever decided to sell in violation of the rule.[250] The provision did not specifically prohibit alienation, but as a practical matter, the court reasoned, the provision would prevent the owner from ever selling it if the land increased in value. Thus the restraint was "substantial" and violated the rule.[251]

Perpetuities Or Restraints On Alienation, 66 A.L.R.3d 1294 (year).

245. *Phillips supra* at note 242. Even where not referring to the Rule Against Restraints on Alienation, courts hold that an option must be exercised within a reasonable time. *See, e.g.*, Snyder v. Bowen, 359 Pa. Super. 47, 518 A.2d 558, 561 (1986), upholding, because not unreasonable, the exercise thirteen years after entry of a purchase option contained in a partnership agreement.

246. *Phillips, supra* at note 242, 383 So. 2d at 614.

247. *Id.*

248. *Id.* at 615. The option in this case set the purchase price at the optionor's purchase price plus the cost of improvements, a formula which effectively denied the optionor compensation for improvements or appreciation and which the court considered to be the equivalent of a fixed price option.

249. *Id.* at 616. Note that the court also concluded that the deed containing the right of first refusal should not be cancelled or rescinded but that equitable relief would be appropriate.

250. Kershner v. Hurlburt, 277 S.W.2d 619 (Mo. 1955).

251. *Id.*; *But see* Barnhart v. McKinney, 235 Kan. 511, 682 P.2d 112, 121

C. *Characterization as a Mortgage*

An option to purchase property may be involved with the loan of money in two different ways which may invite a court to limit its application by characterizing it as a mortgage which must be foreclosed. The lender may be given the option to purchase, being the threat that the option will be exercised unless the loan repaid. This situation was discussed in the earlier section on convertible mortgages.[252] The topic of this section is the opposite situation, where the borrower conveys his land to the lender but retains an option to repurchase.

This transaction may represent the parties intent that the seller have the free choice to repurchase the land at some time in the future. However, this transaction might involve a loan to the optionee who, as the former owner, is coerced into repaying the loan by the threat that he will lose his land if the option expires without being exercised by repayment.[253] What purported to be the purchase of the land was really transfer of the land for the purpose of securing the repayment of the amount loaned and that the payment of the option price is really repayment of the loan. Failure to exercise the option is really default on the loan.

This may be illustrated by the recent case of *Rice v. Wood*.[254] The homeowner was in danger of losing his home because he was behind in

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(1984), in which a right of first refusal, granted to buyers of neighboring land under an installment contract, at the fixed price of $200 per acre was upheld as not unreasonable after considering that the seller offered the land for $1000 per acre, the installment contract was entered into fairly, and the other provisions had been adhered to by the parties. *See also* Brooks v. Terteling, 107 Idaho 262, 688 P.2d 1167 (1984), upholding a similar option and right of first refusal as not unconscionable, but not considering the Rule Against Restraints on Alienation.

252. *See supra* § IV.D.

253. The term includes a sale subject to contract to reconvey as well as a sale subject to an option to repurchase. The operative effect is the same. The "buyer" receives title and is obligated to reconvey only if the "seller" pays the contract or option price for reconveyance. If the intent of the parties was to obligate the "seller" to repay the amount he had received (plus interest) and secure that obligation with the property, then the sale was really a loan and the option is really a disguised mortgage. Conversely, if the parties did not intend to bind the "seller" to repay, then the transaction is a conditional sale. It seems obvious that an option to repurchase is less likely to be characterized as a mortgage that is an executory contract to reconvey because, by definition, the optionee is not obligated to do anything. He has free choice. However, a nonrecourse mortgage would produce the same event. *See* Nelson and Whitman, REAL ESTATE FINANCE LAW, Ch. 3 (1985).

254. Rice v. Wood, 82 N.C. App. 318, 346 S.E.2d 205 (1986).

his mortgage payments. He was approached by a real estate agent with a plan to solve his problems. The agent arranged for the landowner to sell his home to investors who would assume the mortgage, rent the home back to him and give him an eighteen month option to repurchase. When the former owner fell behind in the rent, the investors brought a summary ejectment. That was when the former owner first sought legal help, tried to exercise the option, and counterclaimed to have the option treated as a mortgage. The court held that the factors to be considered revealed that the option might, in fact, be a mortgage. When the documents do not affirmatively show that the parties intended a mortgage, the burden shifts to the optionee to show that a mortgage was intended. The factors here would be sufficient to demonstrate, for example, that the optionee remained in possession after the conveyance, the optionee paid as rent the amount due on the first mortgage, the price paid for the conveyance was not the fair market value of the land but rather the grantees' costs from the transaction and was less than half of the fair market value, the option price was figured as the optionor's costs plus profit, and the negotiations began by the former owners seeking a loan, not a sale. The court pointed out that the requirement that there be a debt which the land was to secure did not mean that there must be a personal obligation on which the optionor could recover a deficiency judgment in the event that the option was not exercised.[255]

A development may legitimately be structured using a sale to a buyer who leases the property back to the borrower. That way, rather than be a lender with only a mortgage on the property, the buyer becomes the owner of the property, secure in his ownership and enjoying the other benefits of ownership such as the tax benefit of being able to deduct depreciation. The seller is now a lessee who makes rental payments which, if an ordinary business expense, are also deductible rather than mortgage payments where deductibility is limited to the interest paid. But, if the lease includes a repurchase option which allows the seller to reacquire the property by paying back to the buyer an amount (plus interest) which the buyer had earlier paid to him, it begins to look suspiciously like a loan secured by a mortgage.

The effect of a court determining that the option should be treated as a mortgage could be substantial. The failure to exercise such an

255. *Id.* 346 S.E. 2d at 210. However, the trial court made a crucial error in failing to instruct the jury that it must find that a debt existed which the land was intended to secure. Consequently, a new trial was ordered.

option would amount to a default on the mortgage. A defaulting mortgagee has an equity of redemption, allowing it to redeem the property by paying off the obligation. The equity of redemption may be exercised until foreclosed and many states require that the foreclosure be by judicial proceedings,[256] and even those that do not require judicial proceedings still require certain notices and procedures to make the nonjudicial foreclosure effective. Consequently, if the option is characterized as a mortgage, the expiration of the option would not terminate all the optionee's rights. Even if time is specified as being of the essence in exercising the option, the defaulting mortgagee could go into equity and redeem, in effect exercising the expired option, until the optionee's rights have been affirmatively foreclosed or until the equities are no longer on the side of the mortgagor due to laches or estoppel. In addition, some states provide by statute for an additional period of redemption following the foreclosure of the equity of redemption,[257] further elongating the duration of the optionee's rights.

D. *Bankruptcy*

Where the optionor has entered bankruptcy, new issues arise. Under the Bankruptcy Code,[258] the debtor's executory contracts[259] and unexpired leases[260] may be rejected. An option is arguably an execu-

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256. For example, Florida by statute requires all mortgages be judicially foreclosed, FLA. STAT. § 702.01 (1985), and further provides that any instrument having the purpose or intent of securing the payment of money shall be deemed to be a mortgage. FLA. STAT. § 697.01 (1985). However, in Rosenthal v. LeMay, 72 So. 2d 289 (Fla. 1954), the court held that the parties to an option did not intend a mortgage. The court considered the testimony of the participants, that the buyer-optionor did not want to make a loan, that both parties were represented by able counsel who characterized the transaction as an option rather than a mortgage, that the sale price was $40,000 for an interest worth more than $100,000, and that the option price was arrived at by crediting the optionor with the estimated rent less the equivalent interest.

257. This is referred to as Statutory Redemption in contrast to the Equity of Redemption. *See* Nelson and Whitman, REAL ESTATE FINANCE LAW §§ 7.1, 8.4-8.8 (2d Ed. 1985).

258. 11 U.C.C. (Bankruptcy).

259. *See* Cherkis and King, COLLIER REAL ESTATE TRANSACTION AND THE BANKRUPTCY CODE § 365.03.

260. *See generally* Cherkis and King, *supra* note 259, at § 365. It seems that an option contained in the rejected lease would be terminated by such rejection absent an intent by the parties that it be severable from the lease, Cherkis and King, *supra*, § 4.02(3).

tory contract which may be rejected under this provision.[261] Clearly, once the option has been exercised it becomes an executory contract which may be rejected. Consequently, the optionee may be deprived of the opportunity to purchase the optioned land, being left with only the monetary claim against the estate.

A purchaser in possession under an executory contract which has been rejected has the right to remain in possession, complete the payments required by the contract with setoffs for damages caused by the rejection, and receive the title on completion.[262] It is unlikely that an optionee will be in possession of the premises under any option other than a lease-option, and a lessee in possession under a rejected lease is already protected by another provision. He may remain in possession for the balance of the term, renew the lease, and enforce the lease terms, apparently including the purchase option.[263]

An optionor may seek the protection of bankruptcy as a way to escape from an option which he thinks is a bad deal. That occurred in *In re Waldron*[264] which involved a voluntary Chapter 13 petition. The optionee had filed an objection to the debtor-optionor's proposed Chapter 13 plan. The Eleventh Circuit held that a financially secure husband and wife could not utilize Chapter 13 solely for the purpose of escaping an option which had turned out to be less profitable than they had hoped. That was bad faith and an abuse of Chapter 13 requiring dismissal of the petition.

That the option has been exercised or the transfer under the option completed prior to the filing of the bankruptcy is no guaranty that the optionee will not be affected. Exercising the option or transferring the property as much as a year before the optionor's bankruptcy could possibly be set aside as voidable preference[265] or even a fraudulent trans-

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261. Cherkis and King, *supra* note 259 at § 365(a).

262. 11 U.S.C. § 365(i) (1982). For a more detailed discussion of the Bankruptcy law, *see* L. CHERKIS, and King, *Supra* note 259, especially § 4.02 on options. *See also* Pedowitz, *The Effect of Bankruptcy or Insolvency on Real Estate Transactions-An Overview*, 20 REAL PROP. PROB. & TR. L. J. 25 (1985).

263. 11 U.S.C. § 365(h) (1982). *See* CHERKIS, and King, *Supra* note 259, § 4.02(3).

264. 785 F.2d 936 (11th Cir. 1986), *cert. dismissed*, 106 S. Ct. 3343 (1986).

265. To be set aside as a voidable preference, under 11 U.S.C. 547 (1982), the transfer must have been made (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent and the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the filing of the petition; (4) made on

fer[266] if the option price was substantially less than the market value. However, a transfer to a good faith purchaser for value could not be set aside to the extent of the value paid.[267] The Bankruptcy Code also allows transfers to be set aside under state fraudulent conveyance laws[268] and the state law may not be limited to transfers which took place within the one year prior to the bankruptcy filing.[269]

E. *Title Defects*

The quality of the title to be conveyed is a serious consideration in a land sale contract. Nearly every modern contract is explicitly conditioned on the seller's ability to deliver marketable title and also requires that the seller use good faith or best efforts to make the title marketable. An option to purchase should specify if the contract of sale which will be formed if the option is exercised will include these terms,[270] because in the absence of a contrary expression, they will probably be found to have been implied. Such term gives the buyer/

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or within 90 days before filing of the bankruptcy petition, or between 90 days and one year before the filing if the creditor was an insider at the time of the transfer; (5) that enables the creditor to receive more than it would under a chapter 7 liquidation or if the transfer had not been made. *See* Cook, *Preferences Under the Bankruptcy Code*, and Seneker and Lewis, *Selected Bankruptcy Aspects of Real Estate Partnerships and Hybrid Debt-Equity Arrangements*, in *Real Estate Bankruptcies and Workouts*, (A.B.A. SEC. OF REAL PROP., PROB. AND TR. L. 1983).

266. To be set aside as a fraudulent transfer, under 11 U.S.C. § 548 (1982) the transfer must have been made, or the obligation incurred, within one year before the filing of the bankruptcy petition and (1) made with the intent of hindering, delaying or defrauding any of the debtor's creditors; or (2) the debtor received less than a reasonably equivalent value in exchange and the debtor was insolvent or became insolvent because of the exchange or the exchange left it with an unreasonably small capital or which was made with the belief or intent that the debtor would incur debts beyond its ability to pay.

267. As a voidable preference under 11 U.S.C. § 547(c) (1982), or a fraudulent transfer under 11 U.S.C. § 544(b) (1982).

268. 11 U.S.C. § 544(b) (1982).

269. *See, e.g.*, In re Copter Inc., 19 B.R. 588 (Bankr. E.D. Pa. 1982) which is provided as an example by Seneker and Lewis, *Selected Bankruptcy Aspects of Real Estate Partnerships and Hybred Debt-Equity Arrangements*, which is Chapter X in *Real Estate Bankruptcies and Workouts* (A.B.A. SEC. OF REAL PROP., PROB. AND TR. L. 1983), at 181.

270. *See* Lewis v. Chase, 23 Mass. App. Ct. 673, 505 N.E.2d 211 (1987), where the optionor's obligations to deliver marketable title and to use best efforts to have the deed delivered in accordance with that term were held to include an implied obligation to eliminate the title defects involved.

optionee the right to cancel the sales contract if the vendor is unable to produce the quality of title promised.[271] Absent a contrary agreement, the cancelling optionee would not be entitled to recover the consideration paid for the option unless the optionor acted tortiously, because he had received what he paid for, the option. The buyers may still elect to enforce the option even if the sellers were unable to provide the title promised.[272]

The discovery of a title defect which the seller asserts he cannot or will not remedy may constitute an anticipatory repudiation of the contract. Where the optionor gives notice of his inability or unwillingness to perform prior to the option being exercised, the issue is whether he has been released from his obligations by the failure of a condition or has committed an anticipatory repudiation of the contract.[273] If he is not released, then, in the words of the Restatement:

> (1) Where an obligor repudiates a duty before he has committed a breach by non-performance and before he has received all of the agreed exchange for it, his repudiation alone gives rise to a claim for damages for total breach.[274]

The optionor's anticipatory repudiation would relieve the optionee of any further obligations.[275] Having received notice that the optionor cannot or will not deliver as required by the option, the optionee is relieved of any obligation to give notice of election to exercise the option or to tender performance as a prerequisite to a suit for damages

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271. Normandy Beach Properties Corporation v. Adams, 107 Fla. 583, 145 So. 870 (1933).

272. *See, e.g.*, in Baker v. Cox, 120 So. 2d 214 (Fla. 2d Dist. Ct. App. 1960).

273. RESTATEMENT (SECOND) OF CONTRACTS § 253 comment a (1981). Such a repudiation is sometimes elliptically called an 'anticipatory breach,' meaning a breach by anticipatory repudiation because it occurs before there is any breach by non-performance."

274. RESTATEMENT (SECOND) OF CONTRACTS § 253 (1981). (Effect of a Repudiation as a Breach and on Other Party's Duties). *See also* RESTATEMENT § 250, which states: "When a Statement of an Act Is a Repudiation. A repudiation is (a) a statement by the obligor to the obligee indicating that the obligor will commit a breach that would of itself give the obligee a claim for damages for total breach under § 243, or (b) a voluntary affirmative act which renders the obligor unable or apparently unable to perform without such a breach."

275. RESTATEMENT (SECOND) OF CONTRACTS § 253 (1981) states: "(2) Where performances are to be exchanged under an exchange of promises, one party's repudiation of a duty to render performance discharges the other party's remaining duties to render performance."

for breach of the option.[276]

The problem of protection from title defects may also arise in the context of exercising a preemptive right. Where the preemptor takes precautions to avoid obvious title problems, the third party whose offer was preempted may claim the preemption was ineffective because it did not match the preempted offer, for example, where the preemptor sought and got an agreement to escrow funds to guaranty that the outstanding mortgage was paid off.[277] That challenge was not upheld because the court concluded that such steps would have been required regardless of who the ultimate purchaser was.

F. *Waste*

The possibility that an optionee in possession may harm the property is really not an option issue. An optionee would not be in possession because of the option, but because a possessory right had been granted in addition to the option. The typical example is the lease-option, where the optionee's possession is due to the lease. Ample remedies are available to a landlord whose tenant is harming the leased premises and the effect that exercising such remedy would have on the tenant's rights under the option has been considered in the earlier discussion of lease-options.[278] Similarly, if the optionee were a licensee with a contractual right to remain on the property, the optionor would have ample remedies should the licensee/optionee breach the terms of that contract.[279]

The interesting question is whether the optionee can prevent the optionor in possession from changing the property or letting it deteriorate.[280] The optionee does not fit the traditional class of parties who

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276. Berman v. Max, 102 Fla. 1094, 137 So. 120 (Fla. 1931).

277. Reef v. Bernstein, 23 Mass. App. 599, 504 N.E.2d 374 (1987).

278. *See supra* § IV B.

279. *See* the discussion of the contractual nature of mortgagee's right to prevent the mortgagor's waste in Camden Trust Co. v. Handle, 132 N.J. Eq. 97, 26 A.2d 865, 154 A.L.R. 602 (N.J. 1942). *See also* 3 POWELL ON REAL PROP. § 428 (revocability of licenses) and § 453(2) (mortgagee's remedy against waste by the mortgagor) (1987).

280. Unless otherwise agreed, under an executory sales contract the purchaser bears the risk of loss due to the doctrine of equitable conversion. Even where there is an agreement that the seller will maintain the premises, the interpretation of that term may lead to litigation. *See, e.g.*, Utah State Medical Association v. Utah State Employees Credit Union, 655 P.2d 643 (Utah 1982), involving the standard by which the maintenance of the building's air conditioning system should be measured.

would be protected by the doctrine of waste. That class was limited to future interest holders, although it has expanded to include the purchaser under an executory contract.[281] An optionee has no interest in the land. He merely has the right to accept an offer, and on acceptance he would become a party to a contract to purchase. Only then would equitable conversion vest an equitable estate in him which he could protect from the malfeasance, misfeasance or even nonfeasance of the legal owner. If he wants protection prior to that point, he must arrange for that in the terms of the contract. Moreover, absent an agreement binding the optionor to maintain the property in its then condition, allowing the optionee to assert power over the land would seem to give him more than that for which he bargained and paid. Conversely, to allow the optionor to despoil the land would seem to condone an anticipatory repudiation of the contract because the optionor will be unable to convey the property as it was when the option was granted.

An example is provided by *Walsh v. Powell*,[282] where the optionee sought to enjoin the optionor from removing the topsoil during the five year option. Although the court refers to the doctrine of waste and to precedents under which the optionee has a substantial interest in the land,[283] it seems to have based its conclusion that an injunction is available on the purpose for which the option was obtained and the principles of equity. The optionee planned to develop the land for residential purposes. The topsoil would be a necessity for that development and the removal of topsoil would be an irreparable injury because equity considers land to be unique. In addition, the question of whether the optionor would be liable for the topsoil already removed under the doctrine of waste is left unanswered.[284]

The case would be better analyzed, reaching the same conclusion, as a question of the terms of the parties' agreement. Because the parties intended that the optionee be able to purchase the land for development purposes, they could not have intended to allow the optionor to block the development and make the option worthless. That option

281. *See, e.g.*, Asher v. Hull, 207 Okla. 478, 250 P.2d 866 (1952).
282. 76 Pa. D. & C. 108 (Pa., C.P. Del. County, 1951).
283. *Id.* at 112.
284. The opinion refers, *id.* at 112, to McCLINTOCK, McCLINTOCK ON EQUITY 299 (2d ed. 1948), which states that where the optionee has removed timber during the term of the option, he will be held liable for waste if the option is subsequently exercised. *But see* Note, *The Vendor's Liability for Permissive Waste*, 48 HARV. L. REV. 821, 825 (1935), indicating that there is a conflict in the few reported cases on the subject.

would be illusory. They must have intended to obligate the seller to maintain the property in its then condition, at least to the extent that the development plans would not be undermined. Consequently, the injunction should have been issued to prevent the optionor's anticipatory breach of the contract because that would have caused irreparable harm to the optionee. Accordingly, damages for topsoil already removed would be determined according to contract principles where there has been an anticipatory breach.[285]

In the absence of an express term, it is possible that courts may find that the obligation of good faith has been implied.[286] Such an obligation might require that the optionor maintain the property pending the optionee's decision to exercise the option or not. However, the extent of the required maintenance and the degree to which the optionor could change the use of the land during the pendency of the option would have to be decided on a case by case basis according to the circumstances surrounding each option. That would be a less than ideal solution for the parties because it would leave them in doubt as to whether the option allows or prohibits certain conduct. However, if the implied term is interpreted to be consistent with the Rule Against Restraints on Alienation discussed previously,[287] it should lead to the rule that the optionor cannot change the property, either actively or passively, so as to interfere with the purposes for which he knew or should have known that the optionee obtained the option but such prohibition shall not unreasonably interfere with the optionor's beneficial use of the property prior to the option being exercised. What would be reasonable would naturally be dependent in part on the duration of the option.

Where the parties need more specificity, they can obtain it by agreeing to explicit terms. The paucity of reported litigation on this subject, however, should not be taken as an indication that it is an unlikely topic for dispute and that, consequently, there is no need for more specific terms. More likely, it indicates that in the event a problem arises, the optionee's most efficient solution is to exercise the option immediately, taking control of the property away from the optionor at

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285. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 334-356 (1981); J. CALAMARI AND J. PERILLO, THE LAW OF CONTRACTS ch. 14 (3d Ed. 1987).

286. *See, e.g.*, the Uniform Commercial Code § 1-203 (1977), "Obligation of Good Faith. Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement." This obligation governs contracts for the sale of goods, commercial paper, documents of title, etc., and similar language is proposed for real estate contracts in the Uniform Land Transactions Act § 1-301 (1977).

287. *See Supra* § V. B.

the earliest possible time and making the optionor liable for any further wasteful conduct after the option was exercised.

VI. Observations and Suggestions

The purchase option in its various forms is a very useful tool for the real estate lawyer, developer, salesman, buyer and seller. It can perform a useful function in encouraging the commerce in, and development of, real property. The major problems discovered in using options arise from three sources. First, parties get into trouble by trying to structure a transaction to appear to be an option when in reality it is something else, such as a loan or a participation in a venture.[288] Options are not the only tool used to restructure a transaction, but it is myopic to imagine that courts of equity or governmental agencies with statutory mandates will not see through a transaction's appearance to its substance. However, a professional may determine that it is worth the risk involved in recharacterizing a transaction because of the potential gain. Such a calculated risk, if taken in good faith, may be justified. However, the cases seem to suggest that many parties have no idea of the risks involved.

The second source of problems is the lack of awareness of the applicability to options of the Rule Against Perpetuities and the Rule Against Restraints on Alienation. It appears that few lawyers or law students ever learned that the Rule Against Perpetuities applies to options, although they may realize that options might be subject to the Rule Against Restraints on Alienation. The difficulty of applying these rules is legendary. Legislative attempts to simplify these rules, particularly as they apply to purchase options, would provide, at least, a partial solution.[289]

The third, and greatest, source of problems is the failure of the parties to appreciate that entering an option involves the parties in two contracts, an option contract and a contract for the purchase of real estate. Parties entering into a purchase contract ordinarily appreciate the complexity of a transaction involving land. Form contracts for even the simplest residential sale involve detailed provisions. They specify

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288. The purpose may be to get favorable treatment, *e.g.*, under the tax code, or to avoid prohibitions, *e.g.*, against usury or clogging the equity of redemption.

289. *See, e.g.*, the UNIF. RULE AGAINST PERPETUITIES, 8A U.L.A. CUMULATIVE ANNUAL POCKET PART (1987), which was approved in 1986 by the National Conference of Commissioners on Uniform State Laws.

the basics, that is, the names of the parties, the date, the description of the property and the purchase price. But they also include such important terms as the quality of the title which the seller is required to produce[290], whether the seller is required to demonstrate the quality of his title,[291] the method by which the seller is to demonstrate the quality of his title,[292] who is to bear the costs of such demonstration, what type of deed the seller is to use to convey,[293] how deposits are to be held,[294] whether the purchase payment is to be escrowed until after the buyer's deed is recorded,[295] whether the contract is conditioned upon the buyer obtaining financing,[296] whether the contract is conditioned upon the results of any inspections,[297] who has the right to possession during the contract period, on whom will the risk of loss fall during the contract period, whether hazard and liability insurance will be carried during

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290. For example, is the title marketable? *See supra* § V. E.

291. Unless the contract specifies, it is generally the responsibility of the buyer to determine the status of the title from the public records. However, in many jurisdictions that is uncommon and would always be impracticable compared to the other methods, *e.g.*, using an abstract or title insurance may be impossible.

292. For example, a lawyer's opinion letter, an abstract or a title insurance policy covering the title.

293. For example, a general warranty deed, a special warranty deed, a statutory warranty deed, or a quit claim deed?

294. For example, who is to hold the buyer's deposit and is it to be held in an interest bearing account for the buyer's benefit?

295. The period between the buyer's last title search and the recording of the buyer's deed is commonly referred to as the "gap." The buyer's concern is that an adverse claim against the land will be recorded in the gap. Consequently, the buyer may wish to verify that no title-clouding document was recorded in the gap prior to the purchase price being released to the seller unless some other method is available to protect him, *e.g.*, title insurance covering the gap period, sometimes referred to as "gap insurance."

296. The financing term may be provided for the protection of the buyer, the seller or both. To illustrate, consider the following suggestions. To protect the seller, a well drafted financing term should require that the buyer apply for the financing within a specified time and obtain a written commitment for the financing within a specified time. Failure to satisfy these conditions should give the seller the choice of whether to terminate the contract and sell the property to another buyer, one who can raise the purchase price. To protect the buyer, a well drafted financing term should specify that if the buyer has made a good faith application for financing and cannot obtain the written commitment at the terms specified to be acceptable, *e.g.*, a mortgage for no less than 25 years and at a fixed interest rate no higher than 11% and charging no more than 3 discount points, then the buyer shall have the right to terminate the contract and recover the deposit.

297. For example, structural, electrical, plumbing or termite inspections.

the executory period, who is responsible for obtaining it and who is responsible for its cost, whether the contract is conditioned upon obtaining a satisfactory survey,[298] who is responsible for the payment of any special assessment which may arise during the executory period, whether the contract is conditioned on obtaining any changes in zoning or conditioned on the zoning remaining unchanged, whether time is of the essence in the performance of the contract and whether the rights are transferrable.

However, even when receiving professional advice, parties frequently fail to provide even for the essentials when using options. They fail to specify the most important details of the option contract itself, especially how long the option is to last and how the option is to be exercised. They leave out almost every detail of the purchase contract which was to arise when the option was exercised.

This regularity of such omissions has led the courts to develop the body of law discussed above which controls the rights of the parties. The courts have struggled to avoid holding options invalid for lack of detail and to give meaning to the probable intent of the parties. However, parties are apparently surprised to discover that the details of their agreements are provided by this growing body of precedents rather than their own wishes. When the application of the precedents is uncertain, they must litigate to solve their disagreements. It is clear that the successful drafting of an option requires more foresight and effort, not less, than the drafting of a sales contract because the option must include the terms for two contracts, both the option contract and the subsequent sales contract.

One approach which might protect the expectations of the parties and eliminate a great deal of wasteful litigation over purchase options would be to provide a statutory option which would provide any terms not expressly agreed upon by the parties.[299] It is more likely that real estate professionals would be aware of the details of a statute and that they would piece together the rules from a myriad of cases. However, in many states the customs as to local terms vary from city to city and

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298. The survey should show that no neighbors are encroaching onto the land and none of the structures being sold are encroaching onto the land of neighbors, possibly leading to unpleasant litigation. It should also show that the structures comply with the requirements for locating structures in the covenants and zoning, *e.g.*, setback requirements.

299. Piecemeal legislation has in some states placed time limitations on otherwise unlimited options, but that eliminates only a small part of the problem. *See supra* § V. B.

county to county,[300] so achieving statewide agreement on what should be the terms would require a tremendous effort, and might prove impossible. It would also produce inflexibility by preventing the natural development of the law as circumstances change. An alternative approach would be to provide certain gap fillers as is done by the Uniform Commercial Code for contracts for the sale of goods.[301] The court could then use such concepts as usage of trade,[302] course of dealing[303] or course of performance,[304] but that simply adds questions of fact to be proved rather than simplifying or clarifying the rights and obligations of the parties. State legislatures are unlikely to perceive that the problems discovered in the use of purchase options would justify the effort required for a legislative solution.

It is also unlikely that encouraging the courts to take a tougher line on the minimum needed for a valid purchase option would make the parties, or even real estate professionals, more diligent in working out and memorializing the terms of their option contracts.[305] In all likelihood, finding poorly drafted or oral options invalid would only result in more optionees being deprived of the benefit of the bargain for which

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300. For example, in a recent survey conducted by the author requesting the contracts of sale used by the local boards of Realtors in Florida, eight different contracts were received from local boards in addition to the one produced and regularly updated by The Florida Bar and The Florida Association of Realtors acting in concert.

301. However, it should be noted that the major proposal to modify real estate contract law in the mode of the U.C.C. has met with an overwhelming lack of acceptance. As of 1987, no state had yet adopted the U.L.T.A. *See* UNIFORM LAND TRANSACTIONS ACT, 13 U.L.A. 469 (1977).

302. *See* U.C.C. § 1-205(2) which defines usage of trade as: "Any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question."

303. U.C.C. § 1-205(1) defines course of dealing as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct."

304. U.C.C. § 2-208(1) states that:

> [W]here the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement.

305. Although, it does seem appropriate to encourage courts to require a purchase option to satisfy the same writing requirements as any other contract affecting real estate, absent express statutory language to the contrary.

they paid, a result which the courts have struggled to avoid. Only a prospective change would be effective anyway. It would probably take decades before the general populace learned from these precedents that options needed a greater degree of detail. The very nature of the option is to allow delay in decision making until some future point so drafting mistakes made before the change in policy would either be caught in the change without a chance to comply, a useful example but one which courts are unlikely to provide, or would be excused, effectively undermining the change.

The probable reason for the last two problem sources also leads to a possible solution. Lawyers and real estate professionals seem to be unaware of the applicability of the rules and of the two contract structure of options because those points are not made, at least not made effectively, in their educations. Options do not seem to get much treatment, if any, in the law school property curriculum[306] or in real estate brokers' licensing courses.[307] Law students easily could and should have

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306. In examining the books used in first year property courses in law schools in the United States, all of the following have extensive sections on the real estate sale transaction but none have a section on options or even mention options in the table of contents or the index: O. BROWDER, R. CUNNINGHAM AND A. SMITH, BASIC PROPERTY LAW (4th ed. 1984); J. BRUCE, J. ELY AND C. BOSTICK, MODERN PROPERTY LAW (1984); A. CASNER AND W. LEACH, CASES AND TEXT ON PROPERTY (3d ed. 1984); J. CRIBBET AND C. JOHNSON, CASES AND MATERIALS ON PROPERTY (5th ed. 1984) (although it does introduce the section with an option case, at 1137); and J. KURTZ AND H. HOVENKAMP, AMERICAN PROPERTY LAW (1987). However, C. HAAR AND L. LIEBMAN, PROPERTY AND LAW (2d ed. 1985) does show the application of the Rule Against Perpetuities to options, at 626-631, as does J. DUKEMINIER AND J. KRIER, PROPERTY (1981) 479-483. Of the texts used to teach advanced real property courses, neither N. PENNY, R. BROUDE AND R. CUNNINGHAM, LAND FINANCING (3d ed. 1985) nor P. GOLDSTEIN, REAL ESTATE TRANSACTIONS (1980) contains any mention of options in the table of contents or the index; and A. AXELROD, C. BERGER AND Q. JOHNSTONE, LAND TRANSFER AND FINANCE (2d ed. 1978) mentions options only in notes (one on 404 regarding the use of straws, another on 408 regarding specific performance, and the third on 425 regarding risk of loss) according to the index. G. NELSON AND D. WHITMAN, REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT (3d ed. 1987) provides a very brief introduction to options, at 887-891, and a discussion of an option possibly being a clog on the equity of redemption, at 259-262, but it also includes references to options in some of the notes and commentary, *e.g.*, the discussion of conditions in contracts on page 107. Texts used to supplement the classroom provide no greater coverage. G. NELSON AND D. WHITMAN, REAL ESTATE FINANCE LAW (2d ed. 1985) only discusses purchase options to the extent that they may be determined to clog the equity of redemption, § 3.2 and purchase options are not included in J. BRUCE, REAL ESTATE FINANCE IN A NUTSHELL (2d ed. 1985).

307. For example, G. GAINES AND O. COLEMAN, FLORIDA REAL ESTATE PRINCI-

an introduction to options as part of the section on real estate contracts in their basic property course when most books introduce everything included in the purchase contract. Requiring real estate brokers to learn more about the basics of options as part of their licensing requirement would also seem to be an easily accomplished improvement.

The message could reach practicing lawyers and brokers through the continuing education courses offered to the respective professions. In addition, Real Estate Boards and local bar associations could provide their members with sample standardized forms for purchase options as they do for sales contracts.[308] The forms could easily be drafted to incorporate by reference the terms of the local real estate contract.[309]

In the final analysis, the rules and theories governing purchase options are not that difficult. The application of those rules to the complicated situation of a possible real estate sale requires that the parties actually take the effort to agree fully to the terms, that they consider foreseeable future events, that they understand the ramifications of their agreements, that they understand the limits which the law may place on their agreements, and that they understand that absent express agreement on a point, the case law will provide the details for their agreement, details which they may not like.

PLES, PRACTICES & LAW (3d ed. 1979) options receive a little more than one page of coverage. In the accompanying Pre-exam Review Outline (2d ed. 1979), options are outlined in one half of a page.

308. The survey of the Boards of Realtors in Florida conducted by the author, and referred to above at note 300, did not reveal a single option form.

309. See the suggested forms provided in 1 FLORIDA REAL ESTATE TRANSACTIONS, Ch. 6B.