

## OPTIONS AND LEASE-OPTIONS – A BRIEF SUMMARY

by  
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*The following Summary is intended to briefly address some of the practical and legal issues that can arise when sellers and buyers<sup>1</sup> enter into an Option Agreement or an Option Agreement coupled with a Rental or Lease Agreement. This Summary is not intended to be a complete explanation of the topic, does not constitute legal advice, and should not be relied upon in lieu of securing competent legal advice. Most importantly, this Summary should not be construed as an invitation for sellers and buyers to engage in risky transactions, but rather give them the necessary information so that they can make informed decisions about the nature of a lease-option transaction, should they decide to consider entering into one.*

**1. DEFINITION.** Simply stated, an option is nothing more than an offer by a seller to a buyer for a fixed purchase price. The offer remains locked in at that price for a certain period of time, during which the buyer can “opt” to buy the property for the agreed price – or walk away with no further obligation. Obviously, there is value to a potential buyer to have this ability to unilaterally buy or not buy, and for this right an option price – or consideration - is normally paid up front. An option agreement differs from an earnest money agreement in several ways, but one of the main differences is that the option price is nonrefundable (assuming the seller doesn’t default under the option agreement), regardless of whether the buyer decides to purchase or walk away. If the option is not exercised by the buyer within the agreed-upon time period, then the right of purchase for the fixed price disappears and the option money is retained by the seller.

**2. RISKS.** There are risks in entering into any legal contract, from sale agreements, to leases, to option agreements, etc. It is for this reason that the use of legal counsel, a lawyer-reviewed form, or a time-tested industry-wide form, is always recommended. However, in today’s marketplace, especially with builders carrying excess inventory and homeowners struggling to sell to get out from under an oppressive mortgage, sellers and buyers are engaging in transactions today that invite more risk, simply to move their property. What follows is an *abbreviated list*<sup>2</sup> of issues that cannot be ignored by sellers or buyers when negotiating options or lease-options.

**(a)** First, if the seller’s property is encumbered by one or more loans, there is a high likelihood that the document(s) contain one or more restrictions on transferring possession (e.g. rental or lease) and/or transferring or selling option rights. Certainly the loan documents contain a due-on-sale clause. This leaves the seller and buyer with two alternatives: (1) Seek permission in advance from the lender – which may not be out of the question in today’s credit market; or (2) Enter into the transaction without seeking the lender’s consent. Obviously, the second alternative is highly risky, as the loan could be called, leaving both parties at risk. Realtors® should never participate, suggest, or recommend any type of transaction which could result in a default of the loan terms. **(b)** Another risk related to the first one is where the buyer is renting the property, while at the same time the seller is not servicing the underlying loan payments - thus creating a risk that the property will soon be foreclosed and the renter will lose the home (and option) entirely. One way to deal with both of these risks (a and b) is to secure a copy of a current title report (not necessarily a *title insurance policy*) and

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<sup>1</sup> Although I will refer to the parties as “sellers” and “buyers,” this is for ease of reference rather than pure technical accuracy. One who grants an option is legally known as the “optionor” and the recipient is legally known as the “optionee.” Only if the option is exercised does the optionor become the “seller” and the “optionee” becomes the “buyer.” And, if there is a lease or rental agreement coupled with the option, the “seller” is a “landlord” or “lessor,” and the “buyer” is a “tenant” or “lessee.” As will be discussed briefly above, each designation carries with it significantly different rights.

<sup>2</sup> This list does not purport to be complete. Your own legal counsel should be consulted for a more complete discussion.

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obtain from the seller written documentation of the underlying loan(s) and the payment history. **(c)** If the title report indicates the existence of deed restrictions, easements, impending LID assessments, etc. – or if the property is a condominium - it is important for the buyer to verify the terms of these documents. As most Realtors® know, many condominium associations have limitations or prohibitions on rental of their units as well as restrictions on certain commercial uses.

**3. RENTAL AND LEASING ISSUES.** Remember, that if you are taking possession under a lease or rental agreement<sup>3</sup>, you are a tenant with all the rights, duties, and liabilities granted under ORS Chapter 90. The same is true of the seller, who, as a landlord, is responsible for making sure that all habitability obligations are observed,<sup>4</sup> among other things. Significantly, sellers who become landlords can no longer access the property in the same manner as before the lease or rental agreement.<sup>5</sup> Except in the case of emergencies, 24-hour advance notice is necessary. One of the more troublesome aspects of the lease-option is addressing the tenant's option rights if he or she is in violation of the lease – e.g. for failure to pay the monthly rent. Some eviction courts are prone to granting tenants with an option greater rights than those tenants without one, which is a primary reason why a well-drafted lease-option agreement is important.

**4. NEGOTIABLE ISSUES.** There are several issues that need to be included in the option in order that it is enforceable.<sup>6</sup> Here is another *abbreviated* list of points to consider: **(a)** Will the option be recorded? Almost all experts would agree that the answer is “Yes.” Otherwise, the seller could transfer or refinance the property without the buyer's knowledge or consent, which could seriously jeopardize the buyer's rights upon exercise of the option. **(b)** How long will the option remain open? Sellers should remember that the longer the buyer has to exercise the option, the greater opportunity the buyer has to “play the market” waiting for the value to go up before exercising. **(c)** How much should the option price be and will it be applied to the purchase price if exercised? The answer to this is really a function of the marketplace, and normally, if it is a seller's market with prices rising, the seller dictates these terms. In a declining market, such as we have today, the buyer has greater negotiating strength. **(d)** What will be the price and terms of the sale? Will the price be based upon today's market, or a price that the parties believe will apply later in the option period? The parties could even agree to an adjustment arrangement, so that the price is lower the sooner the option is exercised. As for other terms, such as financing or other contingencies, there is a school of thought that if the buyer has a few months to live in the property, he or she can decide during that time whether to exercise the option, have the property professionally inspected, and arrange financing, all *before* actually giving notice of intent to exercise the option. **(e)** Will the buyer be able to transfer the option to someone else – i.e. sell the right of purchase to someone else, thus making a profit on the difference – or “spread” between a lower option price (e.g. \$400,000) and a higher market value (e.g. \$500,000).<sup>7</sup>

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<sup>3</sup> Leases are usually for a fixed term, e.g. 12 months, after which time it automatically terminates; while a rental agreement is usually a month-to-month tenancy – i.e. it continues indefinitely until the landlord or tenant gives the other a written 30-day notice of termination.

<sup>4</sup> ORS 90.320

<sup>5</sup> ORS 90.322

<sup>6</sup> Generally, most standard form rental and lease agreements are substantially the same. The primary issue is the amount and date of the rental payment. Accordingly, this Summary does not address many of the terms found in standard lease and rental agreements, since they cannot vary too far from what Oregon law already imposes in ORS Chapter 90.

<sup>7</sup> Even if the option prohibited transfer, a double closing could accomplish a similar result.

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**5. MISCELLANEOUS TERMS.** Since the subject property will probably be a one-to-four family dwelling, Oregon's Property Disclosure law will apply. But when should it be given, and should the 5-business day right of revocation be waived? While some lawyers may argue the point, it seems most reasonable to contractually agree in the option that the best approach is for the seller to give the disclosure form at the commencement of the transaction (before the buyer pays a nonrefundable option price) and then require the waiver of the revocation period (since the buyer can make that decision before exercising the option). Above all, the parties should agree that the option consideration is not subject to any right of revocation; doing so would be nonsensical because it has already been earned. Another issue near and dear to Realtors® hearts is the payment of the commission. When has it been earned and when will it be paid? Logic suggests that securing the option should be compensable – at least half of the commission – and should be paid at the front end of the transaction when the option price is paid – regardless of whether the option is actually exercised.<sup>8</sup> If it is exercised then the balance would be paid at the time of closing. Lastly, Realtors® should be reminded that since the option consideration is not a refundable deposit – but has been earned by the seller at the time the option agreement was executed – it is not “earnest money” and should not be deposited in escrow or a broker trust account.<sup>9</sup> All of these issues should be addressed in writing so there is no confusion later in the transaction.

**6. USE OF EXPERTS.** Option Agreements can be complicated, raising important legal issues. Your real estate broker is not an expert in these areas. ***Buyers and sellers are strongly encouraged to secure additional competent professional advice before entering into an Option or Lease-Option Agreement.***

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<sup>8</sup> *Caveat:* Any special arrangements regarding the payment of a commission prior to closing, should be specially addressed in the listing agreement or by addendum to it.

<sup>9</sup> This information comes on good authority, but if in doubt, Realtors® are encouraged to consult with their principal broker and/or the Oregon Real Estate Agency.