

## **OPTIONS AND RIGHTS OF FIRST REFUSAL**

### **I. INTRODUCTION**

The terms “option” and “right of first refusal” are often misused by real estate practitioners. They mean entirely different things, and it is important that a REALTOR® understand the difference. The purpose of this article is to identify the key terms of both options and rights of first refusal and to provide guidance as to their use.

As an aside, many times an option or a right of first refusal will be given in connection with a lease transaction. With either structure, in order to encourage a tenant to make timely rental payments during the term of the lease, a seller may wish to consider including a clause that provides that the tenant’s purchase rights will automatically terminate in the event of a default (or a series of defaults) under the lease.

### **II. DISCUSSION**

#### **A. Options to Purchase**

An option to purchase gives the holder the right to elect to purchase a property at a particular price. In other words, an option is an irrevocable offer to sell a property for a particular period of time. An optionor cannot revoke the offer during the life of the option. If the option is exercised, it must be executed prior to its stated expiration date. Unlike time deadlines in other contracts, traditionally Michigan courts have strictly enforced time deadlines in option contracts. This is true for the other terms of an option contract as well. So, for example, if an option provides that you must exercise the option

by hand delivering written notice to the seller, do not attempt to exercise your option via email.

An option should be effective upon its exercise. It should not require parties to execute a separate purchase agreement. Because of this, an option contract should spell out the essential terms of the purchase – *e.g.*, title insurance requirements, commission obligations, inspection requirements, tax proration methods, etc. Without these provisions, the option may be difficult to enforce.

It is typical, but not necessary, for some portion of the option fees (or the rental payments received during the term of the lease) to be applied toward the purchase price in the event the option is exercised. Option fees are typically forfeited in the event the option is not exercised.

A sample of purported option that, in actuality, is nothing of the kind, is attached as Exhibit A. (This was an actual proposed “option” presented to a property owner by a municipal attorney. In this instance, the deficiency was cured by simply negotiating and attaching the agreed-upon purchase agreement form to the option contract before it was signed.) A sample form of true option clause is attached as Exhibit B.

To protect their rights in a property as against subsequent purchasers, persons holding an option to purchase, will want to have an interest of record with the appropriate register of deeds. While the option itself may be recorded, oftentimes parties prefer to record a memorandum which simply acknowledges the existence of the option,

but does not make the terms of such contract a matter of public record. A sample memorandum of option is attached as Exhibit C. A party may wish to omit notary blocks from the option agreement itself in order to prevent the other party from later recording the instrument.

## **B. Rights of First Refusal**

A right of first refusal does not give the holder the right to force the seller to sell, it only gives the holder the right to prevent the seller from selling his property to someone else. A right of first refusal gives the holder the right to match the price and terms of another acceptable offer. If you create a right of first refusal, you should make certain that it explicitly states the time the holder has to consider the bona fide offer. If the right of first refusal is not exercised, the seller is free to accept the terms of the original offer. If the original offer is subsequently modified, typically this will trigger the right of first refusal once again. A sample of a right of first refusal clause is:

(a) If Landlord should at any time during the term of this Lease intend to sell or otherwise transfer ownership of the Property, and if Landlord obtains a bona fide offer for the purchase of such Property that is acceptable to it, or enters into any arrangement whatsoever for the transfer of ownership to the Property, Landlord shall deliver to Tenant a written notice (i) stating its intention to transfer such Property, and (ii) including a copy of the bona fide offer for purchase. Tenant shall have the right and option for a period of \_\_\_\_\_ (\_\_\_\_\_) days after receipt of such notice to elect to purchase or take ownership upon the same price, terms and conditions of the sale or other arrangement as are contained in the written notice from Landlord. Exercise of this option shall be by written notice by Tenant to Landlord.

(b) If Tenant does not elect to exercise its Right of First Refusal, then Landlord may close such transaction in accordance with the provisions of the bona fide offer, and this Right of First Refusal shall terminate; provided, however, if Landlord does not close under such bona fide offer, then this Right of First Refusal shall continue as to any subsequent proposed sales or transfers of ownership of the Property during the term of this Lease.

The Michigan Court of Appeals recently described a right of first refusal as a “conditional option” which is dependent upon the property owner’s decision to sell the property. *Philips v Homer (In re Smith Trust)*, for publication opinion per curiam of the Michigan Court of Appeals, issued February 15, 2007 (Docket No. 269549). In that case, the Plaintiffs leased property from Ms. Homer and the lease contained the following provision:

Tenant shall have the right of first refusal to match any bona fide offer to purchase made with regard to the subject property. In the event Tenant fails to exercise his option within 30 days following presentment of said bona fide offer to purchase the option herein granted shall terminate.

The Plaintiffs-lessees had received the following letter on behalf of Ms. Homer, their landlord:

Pursuant to the lease, it is required that you have the right to match any bona fide offer presented. This letter is to inform you that Ms. Homer has a signed purchase agreement with the offer of \$225,000 for the farm. You must notify our office of your decision to exercise your option within 30 days. The thirty days will expire on August 30, 2004. Your offer will be referred to Ms. Homer for her review and final decision. Upon the expiration of that time period, Ms. Homer will be selling the farm. . . .

Prior to both the expiration of the 30-day period and the time that the Plaintiffs-lessees notified Ms. Homer of their election to exercise their right of first refusal, Ms. Homer notified them that she was revoking her offer. The lessees sued to enforce their right to purchase and the trial court threw out their case, finding that the Ms. Homer had properly revoked her offer to sell before it had been accepted. The Court of Appeals reversed the trial court's decision, finding that "this case involved more than a mere offer and acceptance":

Rather, [Plaintiffs-lessees] held a right of first refusal which, when [Ms. Homer] notified [Plaintiffs-lessees] of the bona fide offer to purchase the property, "transmuted" into an option. An option is not revocable for the period specified in the option.

### **III. CONCLUSION**

The purpose of this article is not to encourage REALTORS® to begin drafting their own option agreements and rights of first refusal. Rather, the purpose of this article is to familiarize REALTORS® with terms of such agreements. Clients should always be strongly encouraged to seek the assistance of counsel when considering options/rights of first refusal.

## OPTION AGREEMENT

THIS OPTION AGREEMENT (the AAgreement@) is entered into on the \_\_\_\_\_ day of \_\_\_\_\_, by and between \_\_\_\_\_ (the ACity@) and \_\_\_\_\_ (the AProperty Owner@), upon the terms and conditions set forth below.

**BACKGROUND AND PROPERTY DESCRIPTION:** The City and Property Owner are contemplating the possible sale and conveyance of certain property near \_\_\_\_\_ Industrial Park (the AProperty@) described in the attached Exhibit A. The City desires an exclusive option on said property for a finite period of time so that the City Commission may review background information related to said property and its potential use if purchased by the City.

**AGREEMENT:** The Property Owner hereby grants the City an exclusive option to purchase the Property described in Exhibit A. This option will be legally effective for a 90-day period commencing as of the date of this Option Agreement as said date appears in the initial paragraph of this document.

**TERMS OF OPTION AGREEMENT:** As consideration for this Option Agreement, the City hereby provides the Property Owner \$1,000.00 (One Thousand Dollars), to be held by a mutually agreed upon escrow agent, and which the Property Owner acknowledges is good and valuable consideration. The City can exercise this Option to Purchase at any time within the 90-day period by delivering written notice by regular mail, hand delivery, or facsimile transmission of said intention to the Property Owner at the address indicated above. If this option is not exercised by the City during the 90-day period, the funds described above will be returned to the City without penalty. If said option is exercised, the funds will be applied to the purchase price.

**TERMS OF SALE:** The parties agree that should the City exercise its option herein, the purchase price of the Property will be determined through good faith negotiations between the parties. The parties will negotiate and enter into a purchase agreement as soon as practicable, and will proceed to closing without undue delay.

**ENTIRE AGREEMENT:** This is the entire agreement by and between the parties hereto. Said agreement will be interpreted using Michigan law.

OPTIONEE/CITY:

OPTIONOR/PROPERTY OWNER:

\_\_\_\_\_

\_\_\_\_\_

By: \_\_\_\_\_

By: \_\_\_\_\_

**NOTE: THIS FORM IS PROVIDED FOR DISCUSSION  
PURPOSES ONLY AND SHOULD NOT BE USED  
EXHIBIT B**

**SAMPLE LEASE OPTION CLAUSE**

Landlord hereby grants Tenant the option to purchase the Property (the "Option to Purchase") for a total purchase price of \_\_\_\_\_ (\$\_\_\_\_\_) (the "Purchase Price") by providing notice of the exercise of the Option to Purchase during the term of this Lease (the "Option Period"). The terms of the Option to Purchase shall be as follows:

a. Within fourteen (14) days of the Commencement Date, Tenant shall obtain a commitment for an owner's policy of title insurance with standard exceptions for the amount of the Purchase Price. Upon receipt of the commitment, Tenant shall notify Landlord of any objections to the condition of the title, including any conditions reflected in the commitment which render title unmarketable, within fourteen (14) days of receipt, and thereafter, Landlord shall have thirty (30) days to cure any such defects. If Tenant's objections to the condition of the title are not timely cured, Tenant may either: (i) terminate the Lease and receive a refund of the Earnest Money; or (ii) waive his objections. In the event the Option to Purchase is exercised, Landlord shall provide, at its expense a policy of title insurance in the amount of the Purchase Price pursuant to the commitment approved by Tenant pursuant to this Section. If Tenant exercises its Option to Purchase, any objection to condition of title, including any conditions reflected in the commitment which may render title unmarketable, shall be deemed waived by Tenant.

b. Tenant may exercise the Option by delivering to Landlord written notice of its intent to exercise the Option to Purchase during the term hereof.

c. Upon exercise of the Option to Purchase, Landlord and Tenant shall close the transaction within \_\_\_\_\_ days thereafter.

d. Upon closing of the sale of the Property, Landlord shall convey fee simple

title to Tenant by a warranty deed in recordable form.

e. Upon closing of the sale of the Property, Landlord shall pay all county and state transfer taxes associated with the conveyance. Tenant shall pay the cost of recording the warranty deed. Landlord and Tenant will share equally the title company's closing costs.

f. One hundred (100%) percent of the divisions available under Section 108 of the Land Division Act are to be transferred by Landlord to Tenant upon closing after Tenant's exercise of the Option to Purchase. Landlord makes no representations as to the number of divisions available.

g. Tenant shall have no right to exercise its Option to Purchase if it is in default under the terms of this Lease during the period of time permitted for exercise of the Option to Purchase until it cures any such default during the period for exercise of its Option to Purchase.

h. Tenant shall not have the right to assign its interest in the Option to Purchase without the Landlord's prior written consent.

i. Landlord agrees that at the request of Tenant, it shall execute a Memorandum of Option Agreement which shall evidence Tenant's Option to Purchase, which shall be in recordable form and may be recorded by Tenant with the Register of Deeds for the County \_\_\_\_\_ of \_\_\_\_\_.

**EXHIBIT C**

**MEMORANDUM OF OPTION AGREEMENT**

THIS MEMORANDUM OF OPTION is made and entered into as of the \_\_\_\_ day of \_\_\_\_\_, 200\_\_, between \_\_\_\_\_, a Michigan \_\_\_\_\_, whose address is \_\_\_\_\_ (“Optionor”), and \_\_\_\_\_, a Michigan \_\_\_\_\_, the address of which is \_\_\_\_\_ (“Optionee”).

**WITNESSETH:**

For valuable consideration, Optionor has granted to Optionee an option, commencing on the date hereof (the “Commencement Date”) and expiring on \_\_\_\_\_ (the “Expiration Date”), to purchase a certain parcel of land situated in the Township of \_\_\_\_\_, \_\_\_\_\_ County, Michigan, more specifically described in Exhibit A attached hereto (the “Property”), pursuant to the terms of a certain option agreement dated this date between the parties hereto (the “Option Agreement”).

This instrument is executed for the purpose of giving public record of the fact of the execution of the Option Agreement and all the terms and conditions of the Option Agreement are incorporated herein by reference, and any reference to the Option Agreement may be made by referring to the Liber and Page in which this Memorandum of Option Agreement is recorded in the office of the Register of Deeds of \_\_\_\_\_ County, Michigan.

IN WITNESS WHEREOF, the parties hereto have executed this Memorandum of Option Agreement as of the day and year first above written.

OPTIONOR:

\_\_\_\_\_

By: \_\_\_\_\_

Its: \_\_\_\_\_

STATE OF MICHIGAN                    )  
  ) ss.  
COUNTY OF \_\_\_\_\_ )

The foregoing instrument was acknowledged before me, a Notary Public, this \_\_\_\_\_ day of \_\_\_\_\_, 200\_\_\_\_, by \_\_\_\_\_, the \_\_\_\_\_ of \_\_\_\_\_, a Michigan \_\_\_\_\_, on behalf of said \_\_\_\_\_.

\_\_\_\_\_  
Notary Public  
\_\_\_\_\_ County, MI  
My Commission Expires: \_\_\_\_\_  
Acting in \_\_\_\_\_ County, MI