

OPTIONS: ELEMENTS AND PITFALLS

By Dale Alberstone, Esq.

Let's start with a multiple choice question about options: Assume that the landlord gives his tenant an option to extend the term of the lease by five years provided that the tenant exercises the option in writing on or before Saturday, January 1, 2005. If the tenant gives written notice of exercise of the option on Monday, January 3, 2005, the exercise is: (Select the best answer. The correct answer appears later in this article.)

- A. Unenforceable because the exercise was late.
- B. Enforceable because January 1 is a national holiday.
- C. Enforceable because January 1 is a Saturday, rather than a business day.
- D. Enforceable because a two-day grace period is reasonable.

An option is an agreement between at least two parties where the Aoptionor@ (i.e. the person giving the option) empowers the Aoptionee@ (i.e. the person receiving the option) to exercise (or choose not to exercise) a right under a contract. In a real estate context, options usually involve the right of a tenant to extend or renew the term of a lease or the right of a buyer to purchase the real property.

If the optionee is compelled to exercise the option, then the agreement is not an option at all, but rather a covenant of the party to perform an obligation under the contract. On the other hand, if the party has the right and power, in his discretion, to exercise, or choose not to exercise, the option, then the agreement is, in fact, an option.

Generally the option must contain the following elements: (1) the names of the parties, (2) the price or other consideration that the optionee pays to acquire the option, (3) the time and manner of payment, (4) a description of the property and (5) a statement of the rights the optionee acquires relative to the property.

With respect to options given by lessors to lessees, disputes generally arise over the issue of how much the rent will be in future years for the property if the tenant exercises the option. If the option fails to provide a basis by which the rent can be determined, then the option will be void or unenforceable. For example, consider the following option provision:

A Lessor grants to Lessee an option to extend the within lease for an additional five years under the same terms and conditions, except for the rent which shall be determined by mutual agreement at the time of the exercise of the option.@

Such a provision is merely an agreement to agree. It provides no ascertainable standard by which anyone, including a court, can determine what the rent is supposed to be.

Thus, a landlord who wants to make it appear to a tenant that the landlord is conferring an option might use the preceding language, knowing that the court will not enforce the provision. (Etco Corp. v. Hauer 161 C.A.3d 154)

On the other hand, if the option does not contain the amount of the rent, but provides a basis by which the rent can objectively be determined, then the option will be enforceable. As an example, the following provision would be upheld:

A Lessor grants Lessee an option to extend the within lease for an additional period of five years under the same terms and conditions, except for the rent which shall be the reasonable rental value as of the time of the exercise of the option.@

The preceding option provision is enforceable because the reasonable rental value could be established by the testimony of experts in the field.

Of course, the best way to provide certainty and lessen the likelihood that litigation will ensue is for the

parties to specify the exact rent or to specify that the rent will increase by the same percentage that the consumer price index increases.

Another problem with options is the time for their exercise. If the option does not specify the exact time for exercise, then a reasonable amount of time will be allowed. (Allen v. Smith 94 C.A.4th 1270) The problem, obviously, is that the parties may differ as to what constitutes a reasonable time.

An even greater problem arises where the date specified for the exercise of the option falls on a Saturday, Sunday or legal holiday. In most areas of the law, where the last date to perform an act falls on such a date, the right to perform the act is extended until the next business day. For example, if a tenant is served with a 3-day notice to pay rent or quit, and the third day falls on Saturday, January 1, 2005, the tenant will be allowed until Monday, January 3, 2005 during which to pay his rent. (Lamanna v. Vogner 17 C.A.4th Supp. 4)

The law is different with respect to an option. In the recent case of Gans v. Smull (111 C.A.4th 985), the court held that no statute governs the exercise of an option to extend a lease. Thus, if the lease sets forth a 60-day deadline for the exercise of the option, the tenant must exercise the option on or before the 60th day, even if the 60th day is a Saturday, Sunday or legal holiday. That is a huge trap for the unwary, including attorneys. I suspect that 99 lawyers out 100 would erroneously opine, if asked, that the deadline for the exercise of an option would extend to the next business day following the weekend or holiday. Thus, the correct answer to the multiple choice question is AA.

In the context of buy/sell agreements or leases with an option to purchase, the same rules apply as with leases to extend the term of the option.

Thus, if the contract provides that the lessee has an option to purchase the property at the expiration of the term of the lease and at a price that would be mutually agreed upon by the landlord and tenant at that time, the provision would be void and unenforceable. On the other hand, if the option provided that the price would be at the fair market value at the time of the exercise, then the option would be enforceable even though the parties might not then agree upon the fair market value. With the testimony of qualified appraisers, the Superior Court would determine the market value and compel the landlord/seller to convey the property to the buyer at the so-called market value, as determined by the court.

Similarly, an option to purchase real property must be exercised on or before the deadline date. No grace period is allowed, even if the option does not state that time is of the essence. Under law, time is always deemed to be of the essence in connection with the exercise of an option, unless the option specifically states otherwise (which they never do).

CONCLUSION

An optionee should always be certain that the lease or contract contains very clear and definite terms relative to the option, particularly with respect to the rent which will be charged during the extended term of the lease or the purchase price which will be paid in order to acquire the property.

Similarly, the lessor/seller should be certain that the terms of the option are specific and definite in order to avoid future disputes with the tenant/purchaser and to avoid ending up in expensive litigation which might include the recordation of a lis pendens against the optionor's property.

If the optionor is a landlord who wants to be clever and tricky by making it look like he is giving the tenant an option to extend but in fact have the provision be unenforceable and void, then the lessor better be certain that he follows the exact language of unenforceable options as appear in several California cases (such as Etco Corp., cited above). Of course, the landlord ought to look deeply into his soul before doing so to be certain that he believes that he is not acting unethically or fraudulently by using language which is intended to deceive the tenant into believing that the option is valid under circumstances where the landlord knows that case law will hold it to be invalid.

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The foregoing discussion is intended solely as a general overview of the law and may not apply to the reader's particular case. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation.

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of the Stars, Suite 600, Los Angeles, California 90067-5899. Phone (310) 277-7300, Ext. 202. [Editor's Note: Don't miss Mr. Alberstone's FREE seminar on Saturday, October 23, 2004 at the Los Angeles Convention Center! See page .]