Question of the Month: How do you decide whether to use a purchase and sale or an option agreement?

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When purchasing commercial real estate, most purchasers and sellers are familiar with purchase and sale agreements, but many do not fully understand options agreements. This article explains some of the differences and offers insight into deciding which agreement may be preferable.

What is an option agreement?

At its most basic level, an option agreement is a non-binding right to purchase a piece of property for a fixed price within a specified period of time.

For example, assume you identify a specific property that you may want to purchase only after performing critical due diligence, e.g., you need to raise funds from investors, perform a market analysis, or review complicated zoning and permitting issues. You explain to the seller that you are interested in the property, but you need 18 months to make a final decision. The seller tells you that if you pay $2,000 now, he will reserve your right to purchase the property at a predetermined fixed price anytime during the next 18 months. If you elect not to purchase the property, you simply lose your $2,000 option payment. This is an option agreement.

So how do you decide whether to use a purchase and sale or an option agreement?

How certain are you?

If you are confident that you will purchase the property (subject to standard due diligence), a purchase and sale agreement is likely your best choice. If your decision to purchase the property is contingent upon numerous considerations, such as financing, securing permits, etc., an option agreement may better suit your needs. The reason boils down to what you are actually purchasing. In a purchase and sale agreement, you are beginning the process of purchasing the property itself. In an option agreement, you are purchasing the right to acquire the property for a fixed price over a predetermined period of time.

Timing

If you are ready to act, a purchase and sale agreement may be better for you. A purchase and sale agreement typically has a shorter term than an option agreement, typically requiring closing within 30 to 120 days. Therefore, you will be required to work on an expedited schedule in order to meet the closing deadline.

If you need an extended period of time to decide whether to close on the property, an option agreement may be a better choice. Option agreements often run for a longer period, sometimes several years. This gives you time to line up financing, conduct due diligence inspections, obtain permits, and ultimately decide whether to close on the acquisition of the property. If you need to extend the term of the option, you may be able to do so by making additional option payments.

Deposit vs. Option Payment

A purchase and sale agreement usually involves a deposit that is credited towards the purchase price. In most cases the deposit is a percentage of the total purchase price and is held by an escrow agent. Generally, you will receive a full refund of the deposit if you elect not to close on the property as a result of financing problems, inspection issues, or other contingencies. After the contingency period, the deposit becomes nonrefundable.

An option agreement requires you to make an initial option payment that may or may not be credited towards the purchase price. The size of the option payment usually is tied to the length of the option, with longer-terms requiring larger payments. The option payment is usually paid to the seller and is nonrefundable unless the seller defaults under the option agreement. In rare instances you may be able to negotiate for a refund if you elect to terminate the option agreement due to inspection issues or other contingencies.

Liability

Under a purchase and sale agreement, you are obligated to close after the period for inspections and other contingencies has run, and may even be liable for damages beyond the deposit if you fail to close. Conversely, option agreements allow you to close at any time during the option term, which means you have more flexibility regarding whether and when to acquire the property.

Recording

Purchase and sale agreements typically are not recorded in the applicable land records office because the closing usually will occur within a short time frame following execution of the contract. In rare instances, parties will record a notice or memorandum of purchase and sale agreement. On the other hand, parties usually record a notice or memorandum of an option agreement in the applicable land records office, putting third parties on notice of your option rights in the property.

In summary, option agreements tend to work better for transactions where you may not want to close for a longer period of time. For example, option agreements work well where your decision on whether to close depends on future market conditions, raising capital, securing contracts or permits, or other matters that could take months or years to resolve. You also benefit by being able to (i) "lock up" the property for a longer period of time, (ii) eliminate exposure to liability if you elect not to exercise, and (iii) record a notice of option to put third parties on notice of your rights in the property. Sellers can benefit from option agreements because they will receive a significant nonrefundable option payment instead of what is usually a smaller and refundable deposit under a purchase and sale agreement. This allows the seller to keep the option payment and the property if the purchaser fails to exercise during the term of the option.

Purchase and sale agreements likely are the best option when you have fewer long term contingencies and all the parties are more certain that the deal will close within several weeks or months.

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