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Commercial Classroom: “Options” in commercial real estate - by Ed Smith

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This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

The word “option” is used in several different contexts in commercial real estate.

Option to Extend or Renew

A lease may be written for a specific term and have an option for the tenant to extend the lease term for an additional period, or periods of time (i.e. the term of the lease is five years with a five year options to renew). If the tenant does not exercise the option to extend the lease, the lease ends at the end of the initial term. The rent may be pre-defined for any option period, or determined by a formula, or negotiated at the time each option is exercised. Another method for calculating option rents is a “dual appraisal.” This takes into consideration current market conditions and values. The landlord and the tenant each obtain an appraisal of rental value and use this information to negotiate the future rents.

Option to Expand

A tenant may expect their business to grow and think they may need more space in the future. Rather than move they may look to take more space in the building they are in. At the time they are negotiating their lease they may ask the landlord for an “Option to Expand” or a First Opportunity Clause. Meaning, if more space becomes available in the building in the future, this tenant will be given the opportunity to rent that additional space before it is marketed.

Option to Buy

In a lease a tenant may have an “Option to Buy” the property. This is usually for a specific time period and may be for a pre-determined price. If a longer period of time is given to exercise the option to buy a dual appraisal method could be used to determine the sale price at that time.

Another form of an option to buy is known as a “Right of First Refusal” (ROFR). In this case if the owner decides to sell the property, a tenant with a “Right of First Refusal” would have the opportunity to match a purchase offer from a third party and buy the property. You did not bring the buyer and seller together and would not be entitled to a commission.

In the case of a “Right of First Refusal,” your listing agreement must state that if an existing tenant in the building exercises their ROFR and buys the property, as a result of the offer you presented, you are entitled to a full commission. You must also disclose to your customers and other Brokers, if you are co-broking, that someone has a “Right of First Refusal” to buy the property.

Option to Purchase

When a property is on the market for sale a potential buyer may obtain a “Purchase or Sale Option” from the owner. Effectively the buyer is purchasing the right to buy the property within a specific period of time. The owner is being compensated for taking the property off the market and not selling it to anyone else during this time period.

For example, a sales option could be used when a property is desired for a use that will require a change of zoning. In some areas the procedure could take a long time. An owner may not want to sell their property “subject to” zoning approval and wait to close. A “Purchase Option” would compensate the seller for taking the property off the market and give the buyer time to obtain their approvals. The monies paid for the sales option are fully earned by the owner. At the end of the option period the buyer must close on the property or the agreement to purchase ends. Frequently if the buyer goes forward with the purchase the monies paid for the purchase option will be credited towards the sale price.

Brokers must be careful that their listing agreements cover all these possibilities and indicate what commission would be due if any of these options are exercised.

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