INTRODUCTION

Real Estate Options: What They Are, How They Work, and Why You Should Use Them

I first want to thank you for investing your money in a copy of *How to Make Money with Real Estate Options*. This one-of-a-kind book was written for serious, rational, reasonable, intelligent, reality-based, goal-driven, and action-oriented adults who are willing to take calculated risks in order to profit from the many money-making opportunities that real estate options provide today. I am a firm believer that a real how-to book should tell its readers precisely what to do while providing detailed instructions on exactly how to do it. I also believe that a how-to book should live up to its title. And I am very confident that this unique book will exceed your expectations on both counts! As you will soon find out, it is packed with step-by-step instructions, ready-to-use worksheets, checklists, letters and agreements, and practical, no-nonsense advice on how to use real estate options to control undervalued properties with immediate resale profit potential.

Learning about Real Estate Options

When I first got interested in using real estate options in 1985, there were no publications available like this book. The scant amount of information that I was about to scrounge up about real estate options told me just enough to be dangerous, but not enough so that I really knew what I was doing. This lack of solid information meant that I did not have the luxury of learning from someone else's mistakes. I had no choice but to go it alone. So, how did I become my own real estate option expert? I did it the old-fashioned way. I went out on my own and learned the hard way how real estate options really work. I did a lot of research, talked to a lot of knowledgeable people, and asked a lot of questions. Then, I went out and bought some real estate options and made the inevitable mistakes, which I learned from. And while all of this was going on, I took copious notes to keep track of my trials, tribulations, numerous mistakes, and firsthand experiences as a real estate option investor. Those notes are the basis for this book.

What You Need to Know about Real Estate Options

Real estate options are a little known and seldom used investment strategy probably because the only time that most people ever read or hear anything about real estate options is when they are bandied about, willy-nilly, on real estate web site message boards or discussed at real estate investment club meetings by people whose collective knowledge of the subject would not fill a thimble. However, when fully understood, properly prepared, and used correctly, real estate options are an excellent way to conserve capital, create leverage, reduce risks, and gain control of properties with immediate resale profit potential. But, to avoid the potential problems and pitfalls that plague most uninformed and unsuspecting real estate option investors, you first need to know:

1. The difference between a straight or naked real estate option and a lease-option.
2. What a real estate option is.
3. The seven elements of a real estate option transaction.
4. How a real estate option transaction works.
5. The legal status of real estate options in your state.

The Difference between a Straight Real Estate Option and a Lease-Option

First things first: There is a world of difference between the straight or naked real estate options that I am writing about in this book and the rather ubiquitous lease-options that everyone and their brother has written about over the past 10 years. For starters, the real estate option agreement that I am writing about is a stand-alone document, which is not part of a lease agreement. Second, under the terms of a lease-option agreement, the lessee-optionee takes possession of the property under lease and is legally obligated to pay a monthly lease payment. The only payment required on a real estate option is a one-time option consideration fee. And unlike real estate options, lease-options violate the loan due-on-sale clause contained in residential mortgage or deed of trust loans. In other words, in the event that a lender discovers that a property owner has entered into a lease-option agreement, the lender could call the mortgage or deed of trust loan due and foreclose if the loan was not paid off in full.

Often, people confuse a real estate option with a right of first refusal. The main difference between a straight or naked real estate option and a right of first refusal is that a right of first refusal is the right to match a bona fide purchase offer from a third party, whereas a real estate option is an irrevocable right to purchase property, usually at a pre-determined price, within a specified time period. For example, most commercial leases include a right of first refusal that gives the lessee the right to match any written offers that the owner may receive to purchase the property under lease.

The Definition of a Real Estate Option

In general legal terms, a real estate option grants the party owning the option, the optionee, the exclusive, unrestricted, and irrevocable right to purchase property from the party selling the option, the optionor, during the specified period of time that the real estate option is in effect.

A Real Estate Option Grants Only an Irrevocable Right to Purchase Property

I want to state right from the get-go that the only thing that a straight or naked real estate option grants is an irrevocable right to purchase the property under option within the option period. Nothing more! An optionee has absolutely no beneficial or equitable interest whatsoever in a property under option. Furthermore, in my professional opinion, the creation and sale of a straight or naked real estate option does not violate the due-on-sale clause contained in government-backed and conventional mortgage or deed of trust loans secured by a lien on residential property containing five or fewer units. Again, in my professional opinion, there is absolutely no way that any lender can legally exercise its option pursuant to a due-on-sale clause on discovering the creation and sale of a straight or naked real estate option. Why do I hold this opinion? Because Title 12 of the Code of Federal Regulations refers specifically to lease-option contracts, but makes no mention whatsoever of straight or naked real estate option to purchase contracts. Real estate options are not covered under Section 591.2 (b) of the Code of Federal Regulations that defines the due-on-sale clause as follows:

> Due-on-sale clause means a contract provision which authorizes the lender, at its option, to declare immediately due and payable sums secured by the lender's security instrument upon a sale or transfer of all or any part of the real property securing the loan without the lender's prior written consent. For purposes of this definition, a sale or transfer means the conveyance of real property or any right, title or interest therein, whether legal or equitable, whether voluntary or, by outright sale, deed, installment sale contract, land contract, contract for deed, leasehold interest with a term greater than three years, lease-option contract or any other method of conveyance of real property interests.

Furthermore, the creation and sale of a straight or naked real estate option does not transfer any legal or beneficial interest in the property under option until after the option is exercised. The transfer of the property or a beneficial interest in borrower is the standard loan due-on-sale covenant, which is included in all Fannie Mae and Freddie Mac conventional residential mortgage and deed of trust loan documents. It states in part:

> "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

During the course of researching this book, I found no court cases nationwide in which a residential lender has exercised its loan's due-on-sale clause and declared a loan to be in default upon discovering that the borrower had created and sold a straight or naked real estate option on the property securing the mortgage or deed of trust and promissory note.

The due-on-sale clauses included in almost all commercial mortgage or deed of trust loans do not specifically prohibit the creation and sale of a straight or naked real estate option on the property securing the mortgage or deed of trust and promissory note. The fact is that other than government-backed multifamily loans, most commercial mortgage or deed of trust loans are one-of-a-kind loan instruments written specifically for the property securing the loan and almost never contain any prohibition against creating and selling a real estate option.

Real Estate Options and the Doctrine of Equitable Conversion

Under what is known as the *doctrine of equitable conversion,* once a real estate purchase agreement is signed by all parties and becomes effective, the buyer becomes the equitable owner and the seller retains bare legal title to the property under agreement. However, under a real estate option, the equitable conversion does not occur until after the option is exercised and not when the real estate option agreement is signed by all parties and becomes effective. This is because there is no legal obligation to buy and sell until after a real estate option is exercised. After a real estate option is exercised, the optionee-buyer retains equitable ownership of the property.

The difference between a real estate option agreement and a standard purchase agreement is that there is no contractual obligation to purchase the property. For example, when a buyer and seller sign a purchase agreement, they become legally obligated to buy and sell the property under contract, and either party can be sued if he or she fails to do so. However, when an optionee and optionor sign a real estate option agreement, the optionee has no contractual obligation to purchase the property under option. An optionee can let a real estate option expire, and an optionor has no legal recourse against the optionee.

Why a Straight Real Estate Option Agreement Is Not an Executory Contract

An executory contract is generally defined as: “a contract where both parties have an obligation to perform in the future.” And state and federal courts nationwide have traditionally held the view that straight or naked real estate options are unilateral contracts, under which the obligation to perform rests solely on the optionor, while the optionee is under no obligation to do anything whatsoever. The only notable exception to this is when an option agreement is included in a federal bankruptcy petition and the optionee has notified the optionor of his or her intention to exercise the option prior to the bankruptcy petition being filed.

The Seven Key Elements of a Real Estate Option Transaction

A real estate option transaction consists of the following seven key elements:

1. *Optionee:* Optionee is the party buying a real estate option. Once a real estate option is exercised, the optionee becomes the buyer.

2. *Optionor:* Optionor is the party selling a real estate option. Once a real estate option is exercised, the optionor becomes the seller.
3. *Real estate option:* When an optionee buys a real estate option, he or she buys an exclusive, unrestricted, and irrevocable right and option to purchase a property at a fixed purchase price within a specified option period.
4. *Option consideration:* Option consideration is the amount of money paid by an optionee to buy a real estate option from an optionor.
5. *Option period:* The option period is the specific period of time stated in the real estate option agreement in which the option is in effect.
6. *Exercise of option:* The exercising of a real estate option occurs when the optionee notifies the optionor, in writing, that he or she is going to exercise the real estate option and purchase the property under option.
7. *Expiration of option:* A real estate option expires when an optionee fails to exercise his or her real estate option within the option period stated in the real estate option agreement.

How a Real Estate Option Transaction Works

Here is a sequential outline of the mechanics of a real estate option transaction:

Step 1: The optionee pays a real estate option fee to the optionor.

Step 2: The optionor grants the optionee the exclusive, unrestricted, and irrevocable right and option to purchase a property at a fixed purchase price during the option period by executing a real estate option agreement with the optionee.

Step 3: The optionee assigns or exercises his or her real estate option or lets it expire.

Step 4: Once exercised, a real estate option agreement turns into a bilateral agreement in which the optionee becomes the buyer and the optionor becomes the seller.

Step 5: The seller transfers the property's title to the buyer at the closing.

The Legal Status of Real Estate Options Varies from State to State

Unfortunately, there's no Uniform Commercial Code equivalent for real estate options. The legal status of real estate options varies from state to state. In most states, the legal status of real estate options has evolved over the years from a combination of common and case law. The case law that regulates estate options in most states is the result of various lawsuits involving legal disputes between optionees and optionors over the use of real estate options. To know the legal status of real estate options in your state, you should consult with a board-certified real estate attorney who is familiar with how real estate options work in your state. I suggest that you ask your real estate attorney the following four questions:

1. What constitutes a valid and fully enforceable real estate option agreement?
2. Does a real estate option, prior to its being exercised, create an estate in land?
3. Can a real estate option be recorded in the public records so it constitutes constructive notice?
4. Does a real estate option violate any rule against perpetuities that your state may have?

In some states, most notably California, courts have ruled that real estate options are personal property rather than real property. For example, in a federal bankruptcy case, *In re Merten*, 164 B.R. 641 (Bankr. S.D. Cal. 1994), the court ruled that under applicable California law, an unexercised option to purchase real estate is *personalty*—personal property—and not *realty*—real property. I suggest that you check with a real estate attorney to find out if real estate options are considered to be personalty or realty in your state. Your state's real property statutes should be available online via the Internet or at your county's public law library. If there is not a public law library in your area, check with your local public library to see if they have a current copy of your state's civil statutes. A listing of state statutes, by subject, is available at the following web site: www.law.cornell.edu/topics/state_statutes.html.

No Licensing Requirement to Buy and Sell Options for Your Own Account

Every once and awhile, I will read on the Internet that a private individual investor, acting as a principal on his or her own behalf, must have a real estate salesperson's license to buy and sell real estate options. This is unadulterated bullspit! The fact of the matter is that there are no states that have licensing requirements for private individual investors who act as a principal when buying and selling real estate options.

Why You Should Add Real Estate Options to Your Repertoire of Strategies

Typically, many real estate options are bought more on speculation than on anything else. However, buying real estate options on speculation is not what this book is about. If you follow the advice contained in this book, all you should be doing is changing your name from buyer to real estate optionee. When used properly on the right types of undervalued properties, real estate options provide an excellent low-cost, low-risk, high-profit potential property control technique, which knowledgeable, savvy investors should add to their repertoire of real estate investment strategies. The real estate option strategies outlined in this book are based on a very simple concept:

1. Buy a low-cost real estate option on an undervalued property with immediate resale profit potential.
2. Package the property under option to highlight its best future use.
3. Market the property under option on the Internet to potential buyers worldwide.
4. Sell the real estate option on the property for maximum profit.

Twenty-Four Good Reasons to Buy Options Instead of Properties

I am willing to bet anyone an ice cold case of Beck's Beer that the numerous commercial real estate market meltdowns that have occurred during the past 30 years would not have been so severe if the high rollers had bought more real estate options instead of properties. In this way, if they did not want to exercise their real estate options, they could have simply let them expire, and that would have been the end of it. And they would not have incurred any of the transaction, maintenance, management, holding, and debt service costs that eventually forced them to go belly-up. In other words, they would not have been saddled with the financial responsibility and personal liability that go along with outright property ownership, and they automatically would have avoided having to:

1. Fill out intrusive loan applications.
2. Qualify for new loans.
3. Make monthly loan payments.

4. Circumvent loan due-on-sale clauses.
5. Worry about liability lawsuits.
6. Support negative cash flows.
7. Contemplate being foreclosed on.
8. Collect tenant rental payments.
9. File tenant eviction lawsuits.
10. Chase deadbeat tenants.
11. Go into debt.
12. Buy any property.
13. Pay outrageous loan fees.
14. Assume existing loans.
15. Make expensive property repairs.
16. Babysit tenants.
17. Fret over escalating property taxes.
18. Fill vacancies.
19. Pay exorbitant property insurance premiums.
20. Maintain property and tenant records.
21. Clean up after messy tenants.
22. Pay transaction costs.
23. Assume financial and personal liability.
24. Manage property.

Potential Risks That You Cannot Control When Using Real Estate Options

Although I consider the use of real estate options to be a relatively low-risk investment strategy, there are potential risks that you cannot control when using real estate options. For example, the property under option could be:

1. Foreclosed on.
2. Placed under the control of a federal bankruptcy court trustee.
3. Condemned by a government agency under the right of eminent domain.
4. Destroyed by fire, storm, or earthquake.
5. Taken as part of a government asset forfeiture lawsuit.

When I was starting out as an option investor, I bought a one-year option on a run-down commercial property in Ruskin, Florida, that belonged to a fertilizer manufacturer. And two months later, the company filed for protection under Chapter 11 of the U.S. Bankruptcy Code, and the property I owned an option on came under the control of a court-appointed bankruptcy trustee. The judge presiding over the case in U.S. Bankruptcy Court in Tampa ruled that my real estate option to purchase agreement was personalty or personal property and that I did not have an interest in the property. The case dragged on for over two years and, in the meantime, my option expired and I was out my $3,500 option fee. The $3,500 lesson that I learned here was to always do a lawsuit search on the individual or business entity that owns the property before I ever plunk down my hard-earned money to buy an option.

Use This Book to Become Your Own Real Estate Option Expert

I want you to use this book to educate yourself so that you become your own real estate option expert. I say this because there are very few sources of reliable information and advice, other than this book, available on straight or naked real estate options. My experiences have shown me that many of the people who claim to know all about real estate options really do not know diddly squat about the subject. Case in point: When I first started using options, I had a title agent swear up and down to me that I was required to purchase documentary tax stamps whenever I recorded a memorandum of a real estate option agreement in the public records of my county, Hillsborough County, Florida. This sounded rather far-fetched to me because in Florida, documentary tax stamps must be purchased only when there is an actual transfer of a property's title. So, I called the manager at the Hillsborough County Clerk of the Circuit Court Recording Department and asked her about it. Guess what? Just as I had suspected, the title agent was chock-full of what makes the grass grow greener. From that point on, I stopped using title companies and started using a board-certified real estate attorney who was very well versed on the inner workings of real estate options. I also learned a very valuable lesson: When it comes to advice on real estate options, trust no one, assume nothing, verify everything, and be prepared for anything. In this business, you just cannot afford to blindly rely on the advice given to you by so-called experts. You must be able to verify everything your advisers tell you. And if you cannot confirm that what you are being told to do is correct, there is an excellent chance that you will end up being what I call a mushroom investor—an investor who is kept in the dark and fed a lot of bullspit by his or her advisers!

Twelve Sound Rules That You Should Follow as a Real Estate Option Investor

Finally, this introduction would not be complete if I did not include the following 12 sound rules that you should follow as a real estate option investor:

Rule 1: Know what you do not know.
Rule 2: Do not buy problems that you cannot solve.
Rule 3: Make your profit when you buy.
Rule 4: Have an exit strategy before you enter into a deal.
Rule 5: Anticipate situations before they become problems.
Rule 6: Concentrate on doing what you do best.
Rule 7: Set a goal, make a plan, and work hard.
Rule 8: Always take the path of least resistance.
Rule 9: Buy locally and sell globally.
Rule 10: Avoid doing business through third parties.
Rule 11: Assume nothing, verify everything, and be prepared for anything.
Rule 12: Do what you say you are going to do when you say you are going to do it.

How to Contact the Author

Please feel free to contact me if there is something that you still do not understand after reading this book twice. Unlike 99 percent of all real estate authors in America today, there are no gatekeepers between my readers and me. I answer my own e-mail and telephone, and I am fully wired to communicate from anywhere within the United States. You can e-mail me directly at tjlucier@thomaslucier.com. Or, you can call me direct at my office in Tampa, Florida, at (813) 237-6267. No other real estate author offers his or her readers this free service!