

What Happens to the Rent After Exercise of a Lease Purchase Option?

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A more complete phrasing of the title of this article could be: "Does a tenant in possession of leased property remain obligated under Florida law to continue to pay rent between the date a purchase option set forth in a lease is exercised and the closing date in the absence of a lease provision which specifically addresses that issue?" At first blush (and as emphatically and unanimously stated by a number of

Florida real estate attorneys to whom that question was posed in connection with a recent expert witness engagement), the answer would seem to be a definitive "Yes, of course!" However, as noted by Plato in *The Phaedrus* nearly 2,400 years ago, things are not always as they first appear.¹

The majority rule, in fact, is that the exercise of an option to purchase generally converts a lease to an agreement of sale, and, as a result, a tenant can lawfully refuse to pay rent because that obligation ceases by operation of law. However, express language in the lease to the contrary can overcome that general rule.² Thus, in *Gautier v. LaPof*, the Florida Supreme Court noted "[t]here is no question that a vendee of lands under a contract of purchase is regarded as the beneficial owner thereof from the time the contract is executed."³ The Court went on to explain that the tenants became "the equitable owners of the lot ... when they exercised the option to purchase. The majority rule is that the change of position from optionee to purchaser occurs at the date an option becomes, by acceptance, a contract of sale and purchase."

Similarly, in *Pensacola Wine and Spirits v. Gator Distributors*, a Florida appellate court held, in ruling that ejectment, rather than eviction, was the proper cause of action for a landlord seeking possession of property after a tenant had exercised a purchase option, "the trial court correctly concluded that a lease is terminated when an option to buy is exercised. The vendee then becomes an equitable owner of the property pursuant to an executory contract."⁴ As noted in *Doolittle v. Fruehauf Corp.*, the two steps necessary to exercise an option are: "(1) there must be a decision by the optionee to purchase the property under the terms of the option; (2) the optionee must communicate the decision to the optionor within the life of the option."⁵

Nevertheless, in a dispute concerning the exercise of a purchase option in a lease agreement for commercial property, the appellate court in *Twelfth Avenue Investments v. Smith* did not disturb the trial court's ruling granting the landlord's counts for rent and holdover rent despite its affirmation of the trial court's ruling that the tenant was entitled to specifically

enforce its option to purchase the leased property.⁶ In that case, the court, citing *Doolittle*, confirmed that once notice exercising the purchase option was given, "the option became a bilateral contract, binding on both parties, and susceptible of enforcement by a court of equity in a suit for specific performance." The court went on to state that once the tenant notified the landlord of his desire to purchase the property pursuant to option terms in accordance with the agreed-upon procedure, "the lease ended and the parties were then bound by the terms within the option to purchase." Specifically, the court noted that, "by invoking the right to purchase, the parties entered into a contract of sale, terminating the lease and [the tenant] thereby became an equitable owner of the property." Interestingly, however, as noted above, the appellate court let stand, without explanation, the trial court's determination that the landlord was entitled to rent.

Thus, while it is abundantly clear under Florida law that the landlord/tenant relationship is replaced by a buyer/seller relationship at the moment a purchase option in a lease is properly exercised, Florida law remains unclear regarding a tenant's continuing rent obligation after exercise of a purchase option. In fact, there is no Florida appellate decision which explicitly concludes that the obligation to pay rent ceases immediately upon the exercise of a purchase option when the tenant remains in possession of the leased property. Furthermore, cases from other states support the contrary view that rental obligations may continue after exercise of a purchase option in a lease.

Specifically, in *Cottonwood Hill v. Ansay*, a Colorado court determined that neither party could have anticipated the significant closing delay that resulted from the need to seek a judicial resolution of the large discrepancy in appraisal values.⁷ Thus, the court determined that the landlord was entitled to rental for the tenant's use and possession of the property beyond the "normal anticipated delay" and the date the closing price was actually tendered. After recognizing the general rule that, in the absence of a saving provision, the tenant has no obligation to pay rent after exercise of an option to purchase and, despite the fact that the lease agreement contained no provision for the payment of rent subsequent to exercise of the purchase option, the court chose to allow equity to work in favor of the landlord under the "unique facts" present in that case. The court acknowledged that, "under normal circumstances, it is up to the parties to protect themselves" but justified its determination that rent was payable because "neither party could have anticipated the large discrepancy in appraisal values and the resultant delay caused by the judicial

resolution of the valuation issue. Thus equity dictates some relief since the tenant, "has in practical terms remained as the lessee – both in possession and use of the property." Thus, the court concluded that rents were not due for those days which constituted the normal anticipated delay but that, "[t]hereafter, equity dictates that rents be paid ... through the time of tender of the purchase price."

A Rhode Island Superior Court cited the *Cottonwood* decision in an unpublished opinion⁸ which held, notwithstanding the majority view enunciated therein⁹, it would be equitable to require the tenant to pay the reasonable rental value for the leased premises during the period of time prior to conveyance of title if the tenant retained possession of the property during that time. In rationalizing its determination, the court noted that a tenant holding over after expiration of the lease term is liable for the fair rental value of the premises. Continuing, the court explained that it "must consider the actual positions of the parties for whom equity can fashion some relief." With respect to the tenant, the court reasoned that its surrender of the property before the closing (which would be a logical requirement in the event the lease was, in fact, terminated) would require the tenant "to remove all of its signs and lay off its employees and in turn, permit the [landlord] to erect new signs and hire new employees." Thereafter, at closing, the tenant, "now also an equitable owner of the property, would be required to re-enter and claim possession after payment of the purchase price. Absent some agreement by the parties, the law does not require one to do a vain act." The court then shifted its attention to the landlord, and explained that it would be inequitable for the tenant "to enjoy both the premises and the purchase money without compensating the vendor for either." Thus, the court concluded that it would be equitable for the tenant to pay the landlord "the reasonable value of the premises for its enjoyment of same during this interval prior to conveyance of title."

Thus, courts in three different states have suggested three different approaches with respect to the minority view that payment of rent may be due between the date a lease purchase option is exercised and closing has occurred. In *Twelfth Avenue Investments*, the Florida court simply affirmed, without explanation, the trial court's holding that rent was payable. In *Cottonwood Hill*, the Colorado court found that

the tenant was liable for rent, presumably at the rate set forth in the lease, for the period of time between the closing date, as contemplated by the lease, and the actual closing date. Finally, the Rhode Island court determined, in *Forcier*, that equity required the tenant to pay a reasonable rental (not necessarily the rental set forth in the lease) between the date the option was exercised and closing if the tenant remained in possession of the property during that time.

On the other hand, a majority of other states take the position that no rent is due after the exercise of a purchase option under a lease absent a contrary provision in the lease. This majority view is enunciated by several commentators (see end note 2 below), as well as in *Dartt Dev. Co. v. Tri-State Asphalt Corp.*, a case cited by one of those commentators.¹⁰ In *Dartt*, the court confirmed that Pennsylvania follows the general rule in response to

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the tenant's allegation that its exercise of an option to purchase the leased property terminated its obligation to pay rent. The court specifically stated that Pennsylvania "case law holds that when a lessee of real property exercises an option to purchase that is contained in the lease, the parties' relationship as landlord and tenant ceases to exist and the lease is converted into a contract of sale." Nevertheless, the court ruled that pursuant to the express language in the lease, the parties agreed that the lease would not terminate upon the tenant's exercise of the purchase option, but instead would continue until the landlord delivered the deed and abstract of title to the tenant. Thus, the court found that the express lease language overcame the general presumption that rent was not payable after the tenant's exercise of the purchase option.

In *Industrial Steel Construction v. Mooncotch*, an Illinois appellate court also confirmed the majority view that, "when accepted and exercised according to its terms," an option "becomes a present contract for the sale of the premises" whereupon "the parties' prior relationship of lessor and lessee is terminated, and the resulting relationship becomes that of vendor and vendee."¹¹ Thus, since there was no contrary provision in the lease, the court upheld the majority position that the landlords were not entitled to the rent after the tenant had properly exercised its purchase option.

Notwithstanding the fact that only a few courts have held that rent should continue to be paid after exercise of a purchase option if the tenant remains in possession of the

leased property until closing, that minority approach seems to make far more sense than the contrary approach adopted by a majority of the states. The general rule that the lease is terminated and no rent is therefore payable upon exercise of the purchase option is troublesome for a number of reasons. Furthermore, that position may give rise to significant uncertainty and undue confusion. Taking the majority view to its illogical conclusion could wreak havoc during the period between the exercise of the purchase option and closing since, in addition to the rental obligation, a number of other lease obligations could be impacted by a termination of the lease, including the obligation to maintain the leased property, the obligation to insure and pay taxes with respect to the leased property, the rights and obligations of the parties with respect to the construction of improvements upon the leased property, the obligation to assure that the leased property remains in compliance with applicable laws, covenants, and restrictions, indemnification obligations, and provisions addressing the handling of casualty losses or proceeds from eminent domain or other takings of the leased property.

Furthermore, if the leased property is subject to a leasehold mortgage or the lease has been pledged as collateral for a loan obligation, what happens to that mortgage or pledge upon the exercise of the purchase option? How would liability be apportioned for hazardous substances located upon or beneath the leased property after exercise of the purchase option? Who would be entitled to federal income tax deductions for amortization, depreciation, and similar items between the option exercise and closing? What would be the effect of a holdover rent provision after exercise of an option to purchase? Would miscellaneous lease terms, such as provisions addressing attorneys' fees, venue, notices, and calculation of time periods also terminate upon exercise of the purchase option? How would a provision requiring the tenant to surrender possession of the leased property upon any expiration or other termination of the lease be impacted upon the exercise of a purchase option (which, under the majority view, operates to terminate the lease)? The possible difficulties and conflicts arising under the majority approach seem beyond measure.

Presumably, the rationale with respect to the obligation to pay (or not to pay) rent after a tenant's exercise of an option to purchase would be equally applicable with respect to a tenant's exercise of a right of first refusal to purchase the leased property. In fact, rights of first refusal to purchase are far more likely to be provided to a tenant than an option to purchase in a typical lease.¹² Thus, the concerns addressed in this article may arise in many leases encountered in a real estate attorney's typical practice.

While it may not presently be a standard practice for Florida real estate lawyers to specifically provide in a lease that a tenant in possession of leased property remains obligated

to continue to pay rent (or observe other lease provisions) between the date a purchase option provision or right of first refusal is exercised and the closing date, landlords' attorneys might consider proactively addressing this issue in any lease providing a tenant with a right to purchase the leased property. The inclusion of a simple provision confirming that all lease terms, including the obligation to pay rent, continue after the exercise of a purchase option or right of first refusal until the closing of the purchase and sale transaction should be sufficient to avoid the potential pitfalls outlined in this article. In fact, in light of the current ambiguity under Florida law, such an approach might be well advised. ■

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Endnotes

- 1 "Things are not always what they seem; the first appearance deceives many." *Plato's Phaedrus* (from *Plato in Twelve Volumes*, Vol. 9, translated by Harold N. Fowler, Cambridge, MA, Harvard University Press; London, William Heinemann Ltd. 1925).
- 2 Gregory G. Gosfield, *A Primer on Real Estate Options*, 35 Real Prop. Prob. & Tr. J. 129 (Spring 2000), citing *Dartt Dev. Co. v. Tri-State Asphalt Corp.*, 609 A.2d 171 (Pa. Super. 1992). See also, Jerome D. Whalen, *Commercial Ground Leases*, Practising Law Institute, March 2012, which provides, in §19.1.1, that "[e]xercise of an option to purchase the premises contained in a lease converts the lease to a contract of sale with no continuing rent obligation. There should be express language in the lease that rent should be paid up to and prorated as of the closing of the sale."
- 3 *Gautier v. LaPof*, 91 So. 2d 324 (Fla. 1956), citing *Foxworth v. Maddox*, 137 So. 161 (Fla. 1931) and 32 Am.Jur., *Landlord and Tenant* §300.
- 4 *Pensacola Wine and Spirits v. Gator Distributors*, 448 So. 2d 34 (Fla. 1st DCA 1984), citing *Atlantic Beach Improvement Corp. v. Hall*, 197 So. 464 (Fla. 1940).
- 5 *Doolittle v. Fruehauf Corp.*, 332 So. 2d 107 (Fla. 1st DCA 1976).
- 6 *Twelfth Avenue Investments v. Smith*, 979 So. 2d 1216 (Fla. 4th DCA 2008).
- 7 *Cottonwood Hill v. Ansay*, 709 P.2d 62 (Colo. App. 1985).
- 8 *Forcier v. Woloohojian Realty*, 1991 WL 789771 (RI Super. Ct. 1991).
- 9 Citing 51 C.J.S. 82(1)(b) and 91 C.J.S. 13, the court explained that, typically, "[w]hen an option to purchase land is duly exercised, the relation of landlord and tenant ceases and that of vendor and purchaser arises. Execution converts the option into a binding executory contract for the sale of land. Under Rhode Island law, the purchaser in an executory contract becomes the equitable owner of such land though the vendor still holds legal title." The Court then recognized the majority rule that "absent some express agreement otherwise in the lease, a lessor is not entitled to rent after a lessee has validly exercised his option at purchase, at which time the lessee becomes the vendee in an executory contract for the sale of land."
- 10 *Dartt Dev. Co. v. Tri-State Asphalt Corp.*, 609 A.2d 171 (Pa. Super. 1992).
- 11 *Industrial Steel Construction v. Mooncatch*, 637 N.E.2d 202 (Ill. App. 1994).
- 12 As noted by Jerome D. Whalen, *Commercial Ground Leases* §19.1, Practising Law Institute, March 2012, "rights granted to the tenant to purchase the landlord's fee interest in the premises are relatively unusual in normal occupancy leases; in ground leases, they are common. More likely, the developer may obtain a 'right of first refusal' or similar right."