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**OPTIONS AND RIGHTS OF FIRST REFUSAL
IN REAL ESTATE TRANSACTIONS
LEASEHOLD ISSUES**

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**OPTIONS AND RIGHTS OF FIRST REFUSAL
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This paper deals with the judicially developed rules pertaining to options to purchase, options to lease, and rights of first refusal contained in leases. Due to the manner in which these rights are treated in Canadian common law jurisdictions in the context of leases, there is considerable room for disappointed expectations. Special care needs to be taken in drafting leases and related agreements where these rights are concerned.

It will be useful before dealing with these rules to clarify what is meant by an option to purchase, an option to lease, and a right of first refusal.

Options to Purchase and Options to Lease

For the purpose of this paper, an option to purchase or an option to lease, as the case may be, is the right granted by the owner of land, or a possessory interest in land (the "optionor") to a second party, the "optionee," under which the optionee, within a limited time period, may require the optionor to enter into an agreement of purchase and sale or a lease with the optionee. Since the applicable rules treat an option to purchase and an option to lease the same, they are both referred to in this paper, simply as "options". The option contract will be comprised essentially of (1) an irrevocable offer to sell or lease real property; (2) the terms and conditions of how the contract of sale or lease will be created by the optionee, (3) the statement of the obligation of the optionor and the optionee to enter into a sale contract, or a lease, as the case may be, if the option is exercised and (4) the terms and conditions of the purchase and sale or lease or a mechanism for establishing them. When the option is exercised, a contract of purchase and sale or lease is created.

Right of First Refusal

The right of first refusal is in essence, a commitment by the grantor to the grantee that the grantee will have the first opportunity to purchase the land or enter into a lease should the grantor decide to sell or to lease the land. It may be in the form of an agreement where the grantor must provide the grantee with an opportunity to match an offer to purchase or to lease and to complete the sale or the lease as the case may be. Alternatively, the right may stipulate that when and if the grantor decides to sell the land or to lease the land the grantee has the first chance to purchase at a fixed price or at a price to be agreed upon or fixed by some other means, or to enter into a lease on stated terms and conditions. Another version involves a right in favour of the grantee that if the grantor decides to sell or to lease the grantor must fix a price, or terms and conditions for the lease, as the case may be, and the grantee has the right to purchase or to lease at that price or on those terms and conditions. However, if that first right is not exercised, then the grantor may not sell to a third party at a lower price or may not lease to a third party on better terms and conditions for the third party, without renewing the grantee's first right to purchase or to lease at the lower price or on the better terms and conditions, as the case may be.

Two Basic Principles

There are two basic principles that form the foundation for the rules affecting options and rights of first refusal in leases.

The first basic principle is the general rule (which applies to options and rights of first refusal regardless of whether they are included in a lease) that they are personal rights and cannot be assigned without specific consent to the assignment of the right being given by the optionor or the grantor of the right.¹ If the option or right of first refusal is contained in a lease, generally, the

¹ Canadian Pacific Railway Co. v. Ross & Rosin (1911), 2 O.W.N. 610, 18 O.W.R. 387 (Ont. H.C.)

landlord must consent specifically to the assignment of the right.² However, as will be noted later in this paper, the courts are willing to imply specific consent to an assignment of these rights based on general language in certain cases. See Rules 3 and 4 below.

The second basic principle is that these rights are not considered as ordinary incidents of the landlord and tenant relationship. They are separate rights existing separately from the lease although they may be contained physically within the same document. These rights are not covenants that run with the land. If privity of estate exists between parties, then, covenants that "touch or concern" the land, (that is covenants that affect the landlord and tenant relationship), may be enforced against the respective assignees of the landlord or the tenant. However, there is long standing authority to the effect that options to purchase and rights of first refusal do not touch or concern the land but are merely personal rights that do not run with the land.³ (It will be seen below, however, that although these rights, being personal contractual rights, do not run with the land, their benefit can be assigned in certain circumstances⁴).

These two principles, result in the courts applying certain rules that are of critical importance to the parties dealing with these rights in the context of leases.

² Mus v. Matlszewski [1944], 4 D.L.R. 522, 3 W.W.R. 358 (MAN. C.A.); Re Maynard & Regent Refining (Canada) Ltd. [1956] O.W.N. 251 (Ont. H.C.); Zouvgias v. Chang (1986), 39 R.P.R. 221 (Ont. H.C.)

³ Canadian Pacific Railway Co. v. Rosin *Supra* Note 1, 610, Budget Car Rentals Toronto Ltd. v. Petro Canada Inc. (1989), 60 D.L.R. (4th), 751, 69 O.R. (2nd) 289 (C.A.)

⁴ Conveyancing Law of Property Act, Section 53; Griffith v. Pelton [1958], Ch. 205 (C.A.); Maynard and Regent Refining (Canada) Ltd. *Supra* Note 2; Zouvgias v. Change *Supra* Note 2; Law - Woman Management Corp. v. P.O. (Regional Municipality) (1991) 2 O.R. (3d) 567, 17 R.P.R. (2d) (62 Gen. Div.)

The Rules

The rules are as follows:

1. They Might not Survive on Lease Renewal - An option to purchase or a right of first refusal must be specifically renewed; otherwise the option or right does not extend beyond the initial term of the lease. In the case of *Budget Car Rental Toronto Ltd. v. Petro Canada Inc.*⁵ the Ontario Court of Appeal reviewed several decisions, some of which dealt with rights of first refusal and some with options to purchase, and found that in either case the conclusion was the same, namely, that an option to purchase or a right of first refusal is not automatically renewed or extended along with the lease. The Budget Car Rentals case involved a right of first refusal clause. The decision of the Court of Appeal is summarized in the head note as follows:

"A right of first refusal in a lease is a separate agreement distinct from the demise. Hence, if the lease provides for automatic renewal, the right for first refusal is not automatically renewed. Its renewal must be the subject of an express agreement. There was no such agreement in the lease."

The underlying logic for this conclusion is that an option to purchase or a right of first refusal is not an ordinary incident of the landlord and tenant relationship. The lease agreement and the option to purchase or right of first refusal are two separate agreements, even though found in the same physical document. Since an option to purchase or a right of first refusal is a separate agreement, it must be separately considered and is not automatically renewed or extended when the lease is renewed or extended.⁶

⁵ *Supra*, Note 3

⁶ *Palmer v. Ampersand Investments Ltd.* (1984), 47 O.R. (2d) 275 (H.C.J.) (Pp. 283-284)

It should be noted that the language that the court dealt with in the Budget case was language in which the lease was renewed "on the same terms and conditions". The court held that this was not sufficient to carry the right of first refusal forward. There needed to be specific express reference to the right before it could be carried forward into the renewal period.⁷

2. Express Wording in the Clause Can Make it Automatically Exercisable During Renewal Periods - If the option or right of first refusal by its terms is expressed in the lease to be exercisable during a renewal period then, it will be exercisable even though it is not specifically referred to in a renewal of the lease. In the case of *Hensall District Co-Operative Inc. v. Oud-Boyes Inc.*⁸, the Ontario Court of Appeal held that an option that was exercisable by the tenant "during the term of the lease and the currency of any extension thereof" was sufficient to extend the option along with the lease beyond the initial term of the lease.

3. Specific Mention of the Right is Not Required When a Lease is Assigned if Other Language in the Lease is Sufficient to Indicate an Intention for the Right to Benefit the Assignee - Although the benefit of an option to purchase or a right of first refusal does not run with the land, if the "lessee" or "tenant" under the lease is defined as including "assignees", where the tenant assigns the lease with the lessor's consent, the benefit option or right of first refusal will be transferred with the assignment.

⁷ Justice Lane in the case of *Law - Woman Management Corporation v. Peel Regional Municipality et al*, 17 R.P.R. (2d), 62 at page 78 states: "The law laid down in Budget creates a trap for the unwary when renewing the lease"

⁸ (1991), 3 O.R. (3d) 45 C.A.

The case of *Griffith v. Pelton*⁹ decided by the English Court of Appeal was cited in the Ontario case of *Law - Woman Management Corporation v. Peel (Regional Municipality) et al*¹⁰. The court concluded in the *Law - Woman Management* case, referring to the *Griffith* case and concluded:

"From these authorities it appears that the benefit of an option granted to the "Lessee" passes by mere assignment of the term of the Lease where "Lessee" is defined in the Lease as including "assigns". It is also clear that this result is not dependent upon the nature of the option as an interest in land. Accordingly, there seems to be no reason to differentiate between an option and R.F.R.

In the *Meewasin v. Olfand Landco* (1987), 38 B.L.R. 166, 42 D.L.R. (4th) 730, 62 Sask. R. 216 (Q.B.), Aff'd (1988), 51 D.L.R. (4th) 238, 66 Sask. R. 77 (C.A.), the Saskatchewan Court of Appeal applied the reasoning of *Griffith* to a lease containing an R.F.R. The lease was expressed to be binding upon assigns and contained a lease clause expressly extending rights and liabilities under it to assigns."

In the *Law - Woman Management* case the lease contained the following clause:

"Unless the context otherwise requires the word "Lessor" and the word "Lessee" wherever used herein shall be construed to include and shall mean the executors, administrators, successors and/or assigns of the said Lessor and Lessee, respectively."

The R.F.R. in the *Law - Woman Management* case grants the R.F.R. to the "Lessee". The court held in that case that the assignment of lease had the effect of transferring the benefit of the right of first refusal.

⁹ [1958] Ch. 205, [1957] 3 All. E.R. 75, 101

¹⁰ *Supra*, Note 4

At first there seems to be a conflict between the Budget case and the principle as described above in the *Law - Woman Management* case. This apparent conflict is explained away however, by the following statements of Lane J. set out on page 81 of the report of that last mentioned case:

"How can the criteria for the language required to carry an option or an R.F.R. forwarded into a renewal term logically differ from the language required to assign the same rights. This logical difficulty may be overcome by recalling that the decision in *Budget* was not that an option or R.F.R. could never be carried forward by renewal, but only that this did not happen unless the parties agreed otherwise. In effect, by defining the term "lessee" as including "assigns", the parties in the cases I have just cited may be regarded as having agreed otherwise."

The cases Lane J. refers to in this quotation are *Griffith v. Pelton* and *Meevasin v. Olfand Landco* mentioned above.

4. Certain Language in an Assignment Will be Deemed to Include a Consent to a Transfer of an Option or Right of First Refusal - Even if there is no general term in a lease stating that the word "lessee" or "tenant" extends to and includes its successors and assigns, if the assignment of lease to which the landlord consents contains words that the assignment assigns the lease "and all benefit and advantage to be derived therefrom." the court will imply that the parties intended for an option or right of refusal contained in the lease to be transferred along with the lease, and will give effect to that intention.¹¹

5. Mortgagees Are Not Bound Unless They Have Specifically Agreed to be So Bound - Since options and rights of first refusal are collateral rights that are not normal incidents of the landlord and tenant relationship, when a mortgagee takes possession of property and the tenant attorns to the mortgagee thereby establishing a tenancy with the mortgagee from year

¹¹ Maynard et al and Regent Refining (Canada) Inc. *Supra* Note 3, *Zouvgias v. Chang*, *Supra* Note 3.

to year, the mortgagee is not bound by an option or right of first refusal that is contained in the tenant's lease with the mortgagee.¹²

Some Guidelines

It should be apparent that the rules set out above are not what one might expect intuitively. If you include an option or a right of first refusal in a lease it is best to follow the following guidelines:

- (a) State expressly whether the right will pass automatically with an assignment of the lease.
- (b) State expressly whether the right will be exercisable during renewal or extension periods and whether, on renewal or extension the right will automatically pass.
- (c) Since these rights are treated as personal rights, although they are also considered separate, independent collateral rights, they are not transferable separately from the lease in which they are contained unless there is something stated in the document or that can be implied to that effect. Therefore, it should be stated expressly whether the right is exercisable only by the tenant or whether it is capable of assignment separately from the lease.
- (d) The nature of these rights makes it clear that in a non-disturbance agreement or attornment agreement entered into between a mortgagee and a tenant, the status and enforceability of any option or right of first refusal should be expressly dealt with and confirmed.

¹² Royal Trust Corporation of Canada v. Michael J. Mahoney and Maureen A. Doyle, Ontario Court of Justice (General Division) Unreported Number RE-2930-93 Adams, J. August 26, 1993 and Sadie Moranis Real Estate Limited v. HongKong Bank of Canada, 39 O.R. (3d) 691, Ontario Court (Gen. Div.) March 13, 1998, Cumming J.

- (e) In any document evidencing an assignment of a lease, or a renewal or extension of term refer explicitly to the option or right of first refusal, and state clearly whether it is being transferred, renewed or extended as the case may be.

Conclusion

The pitfalls associated with options and rights of first refusal in the context of leases are another example of the arcane and outdated state of landlord and tenant law in Canada. These rules like the others in this area are in great need of an overhaul.

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