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Maximize Control and Flexibility with the Option Contract

by George Ross

I take calls from business people asking for my help. I am usually asked to help them identify something in their company that is a problem or help them develop a more effective negotiation style. Sometimes it involves reorganizing their work flow, identifying underperforming areas of their business, or even flaws in their business model. And many times, they will hire me for my hands-on advice at their place of business so I can see how their business runs on a daily basis. This is often enlightening, not only to the client, but to me as well.

But in doing this, I have often found that smart and capable business people are not always using all the tools at their disposal in the most effective ways, if they're even using them at all. And that's fine with me; I'm happy to show them where they can improve and how they can get to where they want to go in their businesses. Sometimes, I am able to help these people succeed via ways and tactics they hadn't considered before. But no matter what the business is, or whatever the situation might be, my primary goal is to help them grow their business or just help make their business run better than it does right now.

Flexibility = Control

To that end, from a conceptual point of view, I always emphasize the great need for two things that you must have and be able to use in your business, whatever it may be. Those two things are *flexibility* and *control.* Now, these may sound like opposites, and sometimes they can be, but usually one will give you the other.

If you are not flexible, then that means you have a fixed set of choices; sometimes only one choice. You always want to avoid being limited to only one choice. Because in reality, if you have only one choice, then you really don't have any choices, do you? Therefore, flexibility is a key ingredient for success. However, flexibility is also a key ingredient for control.

What is control? It means that you have the ability to decided when and where you do something—or don't do something—and under conditions that are advantageous to you. If you are doing things that you don't want to do, at times that put you in duress and/or cause your business harm, then you are not in control; somebody else is. Now don't get me wrong, we all have things that need to get done when they need to get done; but for many business owners or people involved in a business transaction, too many decisions are done under the gun, in circumstances that put you at a disadvantage. I see this situation an awful lot these days, and it's not a good place to be; but, as always, I am happy to help where I can.

So today, I want to address a specific request from one of our own Empire Report members that happens to apply to these issues. This person wants to know about different ways to bring flexibility and control to a transaction. There are different ways to control a transaction, but I will focus on one way in particular. So let's talk about a very useful tool that can be used in various business situations where you want to obtain control over a transaction. The tool I'm referring to is the option contract.

Why would you want or need an option contract?

You may need an option contract for the flexibility or control that it offers. For example, an option contract is what you use to "tie-up" a particular piece of property. I've used option contracts many, many times in my career, both in my capacity as a property buyer for my employers such as The Trump Organization, and others, as well as for my own personal transactions. I've always used them when they were needed, and they have been very useful for my purposes.

Now bear in mind, it doesn't have to be real property; option contracts are used throughout the business world. For example, you may have heard of a movie studio optioning a particular film script, or even a novel that they want to turn into a script. Or you can use an option contract to reserve the right to buy a certain stock at a specified price within a defined time frame. When it comes to the option contract, the concept applies across the board. An investor may wish to buy the option for a business or other property that he wants to keep off the market and control it for a given period of time.

So what, exactly, is an option contract?

An option contract is basically an agreement between two parties where one party has the right to do something if they choose to do it on certain conditions. The conditions are usually set up between the two parties.

There can be tremendous flexibility in an option contract, but at the same time, there's no real set formula; it depends upon the specific conditions of the situation. You can get an option to buy a piece of property for a certain price, pending due diligence and the satisfactory end results of it. But truly, options are totally malleable to the situation at hand and are variable depending on the nature of the transaction.

One key point to remember is that there has never been an option granted that is in favor of the party who gave the option, except to the extent that they may get some money in return. Other than that, it is only for the benefit of the party who got the option, not the party who gave the option. But that is usually well understood by both parties.

What are the risks in taking out an option contract?

Say you think that you might want to buy a type of property, but you're not sure, or there is some other possible obstacle—or an opportunity--to consider. In any case, say that you want the right to buy the property while you figure out what you need to know, or gather the necessary financing. And, in the meantime, you want to deny others the right to buy the property, as well as deny the owner the right to sell it or even entertain any offers. So what do you do?

You offer to pay the owner for an option contract to "control" the property and prevent any transactions from taking place. That way, you will have "control" of the property until the option expires, whenever that is. But, you must pay money to control the property. And typically, option money is not refundable. Everything is negotiable, of course, but I've never heard of a refundable option payment. So, whatever you are paying for the option is the extent of your risk. Also, you can include in the option contract the right of renewing the option under certain conditions. You may or may not get that right, but you can try. Either way, the party that grants the option will want some kind of consideration.

Creative Ways to Use Options

There are certainly some creative ways to use option contracts. Say you want to buy a property, but you don't want to pay full price. One way of possibly lowering the purchase price on the property you want is to buy options on one or more comparable properties.

Why would you do this?

You would do it in order to create a bidding situation where you use one seller against the other to lower their selling price. This tactic presupposes that you have similar properties and other factors working in your favor or against the current owners. What I mean by that is that it helps if both owners need to get out of the properties. The owner(s) could be individuals or institutions; it doesn't matter. This tactic works well in today's tough real estate market, especially in the strip mall market because there are many vacant strip malls throughout the country.

What you do is take out an option on both properties, and bargain the owners down to the bottom dollar, taking into consideration any advantages one may have over the other, or the urgency which either or both owners need to unload the properties. You must be reasonably certain that you can get either property for less than the cost of both options. Or, you may negotiate to include the cost of the option into the purchase price. Either way, you don't want to lose money on the options relative to the final price, otherwise you have wasted your money.

Now, another even more devious twist on the optioning of strip malls is to option a property and then sell the property—or pre-sell it—before you even own it.

How do you do this?

You do your homework. You want to find out if new anchor tenants are considering moving to one or more of the locations you are considering as option candidates. You find out the situation with the property. If it is empty, you may end up negotiating with bank; it doesn't matter. You still have leverage if they need to unload the non-performing asset.

Or, you read your local business journal, go to the municipal office, ask around at other nearby business owners what they know about the area. You will be surprised what you will be able to learn. Or, you make a business feasibility study of a strip mall, and any municipal zoning plans. You may even convince the city to relax zoning restrictions, if there are any, to allow new development in that location.

When you have the data that will prove the site would support an anchor tenant like a McDonald's or a Burger King, for example, you tie up the property with an option. Then, you go to them and let them know what an ideal location it would make for them. If they agree, now you can buy the "empty" property from the old owner at a low price, and sell it to the deep pocketed corporation.

Or, even better, you can simply sell your option to McDonald's or Burger King for a huge profit in a short time period. Again, if your research is right on, you can even have two corporations bidding for the option to buy the property. You could easily say, "Fine, I have an option for the property. The price for the property is $1,000,000, and the price of the option is $25,000. It's going to cost you $250,000 over and above the price of the option." This type of transaction happens quite often.

Now, as I said earlier, there is no set formula for an option contract, but say you want the option to purchase a property. How much should you offer for the option to buy? As little as possible. How much is that? It depends upon the time period the property is off the market, and of course, the market conditions at the time. For a $1,000,000 property, you might offer to option the property for 30, 60, or 90 days for $10,000-$25,000. It just depends on the other factors.

Now, let's say that you become aware of a new development being green lit by your city or county. Or, say the economy is recovering and you anticipate greater development activity of one kind or another. You can go around and options several properties for yourself, with the goal of reselling the option contracts to other investors or speculators for a nice profit. This play doesn't even involve buying a property at all. But what it does involve is intelligence, intuition, and some homework, like in the example above. Again, being a savvy investor often means seeing not just what is happening right now, but seeing down the road a bit, anticipating where things will be next quarter, or the quarter after that. Because remember, things change; they always do. They won't stay bad forever and they won't stay good forever.

As for the grantor of the option; what about him?

He's usually very happy about granting an option on his property; it's like found money. It theoretically costs him nothing.

From a legal aspect, however, there are things to be aware of. In many cases, the option period and price is actually part of the same contract to buy; at other times, it may be a separate contract but is still part of the agreement. In either case, you need to know what you want to accomplish with the option contract in place.

But what if you think you will need more time, but can't afford more than one option period up front? What can you do?

You can negotiate for the right to renew the option at the expiration of the contract. What does this accomplish? It gives you control of the property, it gives you time to raise additional money to extend or renew the option; almost as important is that it gives you an opening into establishing a relationship with the owner, and a track record of payment. All of these are all good things to have when you go into your next option period.

Knowing the Owner's Mindset

Now, here is a key point that is not typical of my advice. Usually I recommend that when it comes to contracts, that you prepare them whenever possible. That way, you have the advantage of knowing what is in it and what you have purposely left out. It's up to the other side to figure that out. But in this case, you want the owner of the property to write the contract, especially if they are reluctant to offer you an option or are a hesitant seller.

Why do I advise this? Because in having the other side write the option contract, you will know what they are thinking regarding the property. You will know by the conditions they put in the options contract what is important to the owner, and what he thinks the property is worth and under conditions he would sell it. To put it simple, by letting the owner write the contract, you will have and know the mindset of the owner. That is a tremendous advantage to have. Now certainly, there will be conditions in the contract that you may not be able to live with, and some that you will. But think how much easier it will be to negotiate now that you know where the seller is coming from. You can use the option contract as a way to have the seller bid against himself, so to speak, by showing you his cards.

But he has not only done that; he has given you much more. The owner, the hesitant potential seller, has now, both psychologically and from a business posture, moved in your direction regarding the idea of selling you his property. If you think about it, the owner has now committed time thinking about the idea, put in considerable effort into it—both his and that of his counsel — and of course, he has spent money.

Also, you have gained personal capital as well; you have not only established a relationship with the seller, but have the opportunity to deepen it and get greater levels of commitment from him as you negotiate from the contract he wrote, or even ask for another option, if necessary. That's all progress moving in the right direction.

Malicious Interference

Now, what happens if you option a property, and a third party wants to buy the property? If he goes to the seller and the seller listens to his offer, then the seller has a problem. Both he and the third party are now entering a legal territory that they ought not go. There is such a thing called malicious interference with a contract, which prohibits interfering with the terms of the option

Mud Puddles...

I learned a long time ago that leadership is not something you think about, it's something you do. An effective leader leads not only by example, but by expectation. If you build up your people and let them know that you appreciate their efforts, both verbally and with compensation, they will go through walls for you. If you dominate them, they will resent you, and your leadership is lost.

George Ross

contract. When a property is off the market, the owner is prevented from entertaining offers from other parties.

It's the same situation with a broker. What happens if there is a broker that is involved in the sale who earns a commission if the deal is made? And say that the broker's exclusive right to represent the property expires in 30 days? The seller cannot say to the buyer, "Why don't we wait the 30 days and then do it without the broker?" Believe me, this happens all the time. That is why lawyers make money.

And, this is also why you spell out what protections you require in the options contract. If the grantor has not put in the proper protections, you will need to add them in the contract and insist upon having them in there.

The Straw Man

There is also another way to make a nice living using option contracts for real estate, and that is, becoming "a straw man." A straw man actually purchases option contracts for the purposes of reselling them, or the right to purchase the property for a defined price, for large companies. Why is this smart?

Because whenever a big company expresses interest in a property, the price automatically goes up due to their interest in the property alone. However, by using "a straw man" or front man to make their inquiry, the owner of the property doesn't realize that behind the straw man is a very big corporation with deep pockets. This works best if you have a relationship or can cultivate one with the right property scout for various large companies.

It also works for re-development projects that involve several properties or even a whole block of properties of differing shapes, types and sizes. If a developer goes and tries to negotiate with all these different owners, the same situation occurs; the word gets out and then the negotiations on multiple properties become too complex and too expensive. A straw man can take each option contract under a different name, none of which would raise any suspicions or drive prices up. Brokers often use a straw man to handle these transactions for their development and corporate clients. It is a very legitimate and lucrative business. In fact, once you do one deal, it is much easier to do more for the same company. That's how these things work.

But what if you don't want to use the straw man or bid on a strip mall. Can you still use option contracts to your advantage in you smaller transactions? Of course! Remember, as I said earlier, option contracts can be used with regard to almost any business or property transaction.

Say that you just want to rent a small property for your business, for example; how would you use an option in that scenario? You can go to the landlords of the properties you are considering, and take out an option to lease either property; in these particular economic times, you have an advantage of being able to leverage the demand for tenants and negotiate a lease on terms that are most favorable to you, including build to suit, shorter or longer lease terms, utilities paid, and so forth.

You can also use option contract to buy a single, small property such as a single family home. This is especially true if the property is underwater. You can buy the underwater mortgage and say to the owner, "look, rather than foreclose, I'll give you the option to buy the house back at market value in 5 years. In the meantime, you pay me rent on the house and you get to stay in the property." This is becoming much more common today due to the fact that so many single family homes are underwater right now. I know I mentioned this scenario in a previous issue, so I won't spend too much time on it, but it is another effective and valuable way to use an option to your advantage as the grantor of the option contract, and not just the grantee. As you can see, there are many ways to use an option contract in your business ventures. The key thing to remember is that everything in an option contract is negotiable; there are any number of ways to make them work for you.

All the best,
George

The Gorrie Details

by James R. Gorrie

Fed Can't Fight the Laws of Gravity

In 2006, the housing market was flying high...

An image as good as any other might be my little son's helium filled balloon that got away and flew high up into the sky out of sight…

As soon as his small fist let go of the string, his big, beautiful birthday balloon took flight and soon was only a tiny red dot against the clouds before it disappeared altogether.

My son tearfully asked me where his balloon went and I told him that it would eventually come back down to earth; that whatever goes up must come down. Because as the helium leaked out of the balloon, the laws of gravity would again prevail…And the balloon would indeed crash land—somewhere—in a misshapen heap and utterly deflated.

And that visual brings us back to the housing market.

Housing Market Helium

As you know, by 2006, the housing market was sky high and out of sight…

The string had been let go… There was no controls on lending, no standards whatsoever.

But the helium began to leak out of the housing market in 2007. By 2008, it was falling to earth...

By 2009, there was no market to speak of as millions of homeowners simply walked away from their houses that were worth only a fraction of what they paid for them.

In an attempt to add a little helium to the deflated market and stop the balloon from crashing to earth, the Federal Reserve began buying $1.25 trillion of mortgage bonds in January 2009.

Has this stopped the deflation of housing prices? Not yet. Housing prices on a national average are still falling. They are down 4.1% since 2009, and down 32% from their 2006 peak, according the Case-Schiller Housing Index.

But wait...Isn't the housing market coming back? Aren't housing starts up? True, housing starts are up… But as I've said before in The Gorrie Details, the housing starts that are up are for…rental housing.

And that's a sure sign that the millions of single family homes on the market just aren't moving…and are not expected to in the near future. Apparently, our red balloon still has more helium to lose…and further to fall.

It's a case of positive news in one sector being a negative indicator in the larger sector and the overall economy…

Buying Cheap Does *Not* Make A Recovery

In economics, it's the concept of replacement or substitution. When a preferred item is too expensive, you find and consume a cheaper substitute. So when you can no longer afford to eat steak, you eat more baloney. Is the rising demand for baloney an indicator that your personal economy is on the mend? You get the idea.

Just how crucial is the residential real estate market to real economic recovery in the US? Estimates differ, but it figures to be between 15% - 20% of the economy. That's a pretty big balloon to re-inflate. But that's exactly what the Federal Reserve is trying to do…again.

Yep, the Fed is ready to buy more mortgage loans in 2012. How many? At least $200 billion in new loans, which equals 20% of all new loans.

But that may be just the beginning. According to Barclay's Capital and Federal Reserve officials… The Fed may well end up buying up to $750 billion in mortgage loans this year!

As readers of The Gorrie Details know, the problem in the housing market is not in the supply side… there are 3-4 million empty houses on the market right now… And another million or so that will be in foreclosure this year. In fact, foreclosures are on the rise and will continue to rise in 2012…

So the supply of houses if plentiful. It's the demand side of the market that is lagging. What is the one indicator of demand? Price.

To put it bluntly, the residential housing market is still overpriced. Rather than trying to re-inflate the balloon… Fed Chairman Bernanke needs to let the balloon fall further… All the way, in fact, until house prices touch the ground. Why?

Defying the Laws of Gravity

Because like the laws of gravity, the law of supply and demand works whenever it's allowed to.

Supply is high because prices are too high relative to income levels. Housing prices need to fall in order to meet the new wage levels. Until that happens, the housing market will continue to follow the laws of gravity…And continue to fall until they can't fall anymore. When typical homebuyers can afford a home, they will buy one. Until then, it's not going to happen.

If the key to housing prices were lower interest rates, then the housing market would already be on the road to recovery…

But that part of Bernanke's plan hasn't worked.

His next move? He has decided that more of the same policy is what is required to arrive at…a different result. He even wants to expand the roles of…are you ready for this?...Freddie Mac and Fannie Mae…to support the housing market.

Catching a whiff of that oft-used definition of insanity here? Something about repeating the same actions but expecting a different outcome? Yeah, me too…

And even though the Fed has kept mortgage rates incredibly low the past year… A 30 year rate is around 4%... Home loans are expected to reach a 15 year low in 2012.

Isn't it curious that the income levels are now where they were 15 years ago, too? Is that just a coincidence? Or does it tell us that housing prices should fall to 1996 levels as well… Instead of being at 2004 levels, which is where they are today.

But will that happen?

Will our red balloon be allowed to obey the laws of gravity and come down to its natural level, on solid ground?

If so, then we could reach for the string once more and keep tighter hold of it so we don't lose control of it again…

Will the law of supply and demand be allowed to work? Not if Ben Bernanke can help it.

And those are…*The Gorrie Details*.

Member Mailbag

Questions for Empire Report? Submit them here: http://www.theempirereport.com/questions/

Q. George, I know that you work with very high level business people, and help others reach their lofty goals, but that isn't what I'm interested in. I run a small business and it barely allows me time to see my kids. I know I'll never be a Donald Trump, so what kind of advice can help me to balance family time with my small business ?

A. Your question is bigger than maybe you think it is. Look, it doesn't matter that you are not a billionaire and probably never will be, that fact has nothing to do with you being successful. One person's definition of success is different than another. In your case, you value your time with your family more than making a fortune. You're wise to do so. So, how can I help you become more successful? By helping you get back more of your day to be with your family.

How do you do that? By identifying where you are most needed in the business, and where you are not. Ask yourself what is the crucial activity that only you can do and that you are the best at? Hopefully they are the same. Either way, you need to delegate to others those tasks that you don't do well or don't need to do. That way, you can spend the key hours of the day being most productive. This should yield greater revenues. Or, more likely, you can obtain the same revenues by working fewer hours, because you will be more focused on the moneymaking activities, and letting one of your employees handle the tasks that are not your strengths. You'll have more time with your family and less stress. How's that for success?

Q. George, I have read some of your advice about asset cycles, but I don't feel confident about the economy right now to invest. I am not comfortable going against the grain, so to speak. Am I wrong to wait until things get better before investing?

A. You don't specify the type of investing you're considering, but it really doesn't matter because my advice is the same whether it's stocks, real estate, businesses or whatever. The feeling you refer to is common; you don't want to do anything different than what the crowd is doing. I understand that. It's not a put down, it's human nature. Most people are not comfortable going against the grain.

But going against the grain is where the opportunity is. Now, that doesn't mean just going against the grain for its own sake; you still have to do your due diligence to assess the quality of an opportunity. But in doing so, you'll find that you are more comfortable than you might imagine being when you know what you're getting into. Are all houses a great deal? Of course not; but many areas around the country hold terrific opportunities. The same applies to stocks. Would I suggest you buy shares in Eastman Kodak? Doubtful; but there are plenty of quality firms with prices at book value or even less in some cases. Are they good buys? A lot of them are. Remember, most people see the current state of the economy and project forward; they think that it's always going to be this bad going forward, but it's not the case. It's hard going against the grain, I know; but that's where fortunes are made. —GR

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