



Drafting a Better and More Effective Right of First Refusal

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Land transfers date back to biblical times and have been the subject of an inordinate amount of litigation. Of course, the importance and value of land and the necessity for shelter might help to explain many of the disputes. Some, however, are due to human error, especially those involving the right to purchase property.

A national analysis and survey of right of first refusal litigation over the past 11 years provides a detailed explanation for these disputes. Litigation has ensued mainly as a result of faulty draftsmanship and disagreement over the meaning of the clause in particular contracts. A survey of all 50 states and the District of Columbia revealed only nine states without published decisions stemming from litigation over a right of first refusal ("ROFR") (Idaho, Kentucky, Maine, Nevada, New Jersey, North Carolina, Oklahoma, South Dakota, and Vermont). Other states, including Connecticut, Missouri, Montana, and Ohio recorded at least five decisions involving the ROFR, according to a Lexis/Nexis search. Texas and Virginia produced six decisions, and Florida reported eight decisions of record during the past 11 years. Michigan, Tennessee, and Wisconsin reported at least nine decisions, while Minnesota had 11; Georgia had 17, and Massachusetts published 18 decisions involving the ROFR. New York, by far, has the most published decisions involving the ROFR. Since 2001 alone, 31 New York judicial decisions have been published involving a right of first refusal; twenty-five of them arose from the inability of the parties to agree on the implementation of the provision and/or the failure of the provision to provide adequate guidance. This includes 24 cases decided on appeal.

An overwhelming majority of our nation's decisions resulted from faulty draftsmanship and/or disputes about the meaning of the ROFR clause in a particular agreement.

The intent of the parties provides further support for the premise that rights of first refusal need to be better drafted. The ROFR is one of those clauses in real estate that rarely breeds disagreement. The seller only transfers its land at its option, and the seller has no reason to prefer one buyer to another, since all potential buyers will be paying the same asking price. Thus, a transaction involving a holder of an ROFR involves two parties with the same goal, ie, to transfer land from one to the other at a mutually agreeable price.

Nevertheless, as long as real estate practitioners use the court system to strive for results unobtainable without the leverage of a lawsuit, it may not be possible to eliminate all potential disputes pertaining to ROFR clauses.

Background

In its simplest form, the ROFR contained in a contract or lease generally requires:

- a) that the right holder be notified of any bona fide offer from a third party to purchase the parcel from the current owner;
- b) that the current owner offer the right holder the opportunity to purchase the parcel on the same terms and conditions offered by the third party; and
- c) that the right holder exercise the ROFR by accepting the offer within a specified period of

c) that the right holder exercise the ROFR, by accepting the offer, within a specified period of time.

Enforcing the Actual Terms and Requirements of the Right of First Refusal

Upon receipt of a bona fide offer to purchase from a third party, the property owner subject to an ROFR clause must notify the right holder of the material terms and conditions of the bona fide offer. Upon the right holder's acceptance of the material terms and conditions of the offer stated in the notice, the owner must then provide the right holder with a proposed contract of sale, the material terms and conditions of which must match those stated in the notice. (Alternatively, the owner may simply enclose a copy of the proposed contract of sale to the third party with the notice and refer to the terms and conditions listed in the contract.) Similarly, the right holder's acceptance of the offer must unequivocally confirm that it agrees to the material terms and conditions listed in the notice. (If the proposed contract of sale is the "notice," then the right holder must accept the material terms and conditions stated in the proposed contract.)

Neither buyer nor seller may vary the terms of the proposed contract from the terms of the bona fide third-party offer. For example, a right holder may not "accept" by agreeing to purchase the property at the price offered by the third party but propose to continue negotiating other terms of the offer, such as financing and the closing date. Such action on the part of the right holder does not constitute a proper exercise of an ROFR. "[A] right of first refusal does not give a party a right to purchase the property on any terms so long as the price offered by the third party is met." *M&A Motors, Inc. v. Disco Realty, Inc.*, 24 AD3d 519, 806 NYS2d 244 (2d Dept. 2005).

Similarly, when the right holder has accepted the terms and conditions stated in the notice of the bona fide offer, the property owner may not then vary the material terms and conditions contained in the proposed contract of sale from those stated in the notice of the bona fide offer. For example, in *Danyluk v. Glashow*, 2 Misc. 3d 1005A, 784 NYS2d 919 (NYC Civ. Ct., NY County, 2004), a right holder exercised its ROFR on the basis of a notice from the owner-seller stating that a third-party's offer included a 10-year mortgage. The owner's final contract said that the mortgage would amortize over a 30-year period; this modification constituted a material variance from the accepted offer of sale because the additional amortization period would have increased the right holder's actual purchase cost by \$80,000. The owner's "creative financing" justified the right holder's refusal to sign an agreement that materially altered the terms of the parties' contract.

On the other hand, a right holder was granted specific performance where an ROFR clause stated: a) that the purchase price was to be payable in full at closing, and b) that the seller shall be obligated to offer the property to the right holder on the same terms and conditions as made in a bona fide third-party offer to the seller. The court granted the right holder specific performance because the seller accepted an offer to purchase the property for \$1,150,000, but the third-party did not make a simultaneous down payment of 10% or \$115,000.00 upon acceptance of the offer as demanded by the seller, and because the down payment term was not authorized or required by the ROFR, and the third party's offer contained no such down payment requirement. *Degree Sec. Sys., Inc. v. FAB Land Corp.*, 302 AD2d 555, 756 NYS2d 248 (2d Dept. 2003).

Choosing a Pre-Sale Price May Violate Laws Against Restraints on Alienation

Some ROFR clauses contain a preset ROFR price, or a formula by which the ROFR price will be set, when and if the owner decides to sell. Attorneys need to negotiate and draft such provisions very carefully. The price — or the formula the parties adopt to set the price — at the time they enter into their agreement may substantially undervalue the property when the ROFR is triggered by the owner's decision to sell. An ROFR with an unreasonably low price "cap" will preclude an owner from obtaining a favorable market price for his property.

Attorneys should therefore be aware of states that retain the common law rule against unreasonable restraints on alienation or a state's Rule Against Perpetuities; invocation of the rules in the appropriate case will render an ROFR null and void, and, therefore, unenforceable. The common law rule evaluates the reasonableness of the restraint based on

its duration, purpose, and designated method for fixing the purchase price. An ROFR will generally not be unlawful when conditioned on payment of "market value" or a sum equal to a third-party offer.

Drafting the Right of First Refusal

As noted above, a ROFR is enforceable when the price of the property, the time the holder has to accept the ROFR, and the ROFR's purpose are deemed reasonable. ROFRs specifying a fair market or market-produced sales price have been upheld, as well as ROFRs that have designated a 90-day period for exercising or accepting the ROFR.

The practitioner drafting an ROFR should require that the election to exercise the ROFR be in writing and completed within a narrow time frame and that it be delivered by certified mail or by use of another mail tracking device. The ROFR holder should be required to close within a certain number of days from delivery of the executed contract.

A signed contract of sale with terms that are identical to those contained in any offer received from a third party should be due along with a 10% down payment within a short time (eg, 10 business days from the date of delivery). The ROFR provision should specifically state that the purchase shall not be contingent on a mortgage or any other financing.

Because the ROFR is already a deterrent to potential buyers who see it as an impediment to closing a deal, these strict provisions should assist in selling the property without any major impediments. For verification purposes, the ROFR provision should also include a requirement that the seller provide written proof of any offers, including the interested party's name, upon a timely written request. This should eliminate the frequent disputes that cause litigation where the ROFR holder believes that the seller does not have an actual buyer and is using the ROFR to raise the sale price.

To provide an incentive for good behavior by a lease holder, the ROFR provision should state that it may only be exercised if the tenant has been in good standing and in compliance with the lease provisions throughout the term of the lease and at the time of the exercise of the ROFR.

The provision or agreement should include another much-litigated topic — the revocability of the ROFR. The provision should note that the ROFR is revocable at any time until a fully executed contract of sale has been delivered so long as the third-party bid is also rejected. The agreement should include a provision that the ROFR is terminated on the day the lease ends to avoid unnecessary litigation.

Other methods to reduce the risk of litigation and to forge a sealed deal may include providing for a one-time right to exercise the ROFR, the prohibition of assigning the ROFR, the ability to exclude companies from the ROFR in which the seller is more than a half-owner, and proof of financing from the ROFR holder to demonstrate the ability to purchase the property. The seller should have sole discretion to decide whether the ROFR holder has provided satisfactory evidence of its financial ability to close. The ROFR should also immediately be deemed terminated upon the assignment or sublet of the lease.

When drafting the ROFR, it should be noted that a court will not enforce an ROFR against any seller that conditions acceptance on terms that are impossible to fulfill. In addition, unless written into the ROFR, courts will not allow the landlord to add a *carte blanche* menu of conditions to the terms of the deal. Of course, if the ROFR holder is required to execute the same contract and conditions as an interested third party, this will not become an issue.

Careful Drafting of the Deed to Include a Right of First Refusal

Attorneys need to be particularly careful in any transaction in which both the contract for the sale of real property and the deed for the sale contain an ROFR clause. The ROFR in the deed may inadvertently contain a more limited right than that contained in the contract; the ROFR of the contract is merged into the deed, unless the contract expressly provides that its provisions shall survive the transfer of title. Consequently, the more restrictive ROFR will govern if the right is ever exercised.

In a situation where a parcel of property was conveyed by deed to the buyer “and assigns forever,” but a separate ROFR to purchase an adjacent parcel of property was given to the buyer without such language, the ROFR was held to be personal to the buyer alone, and the assigns of the property the buyer had purchased from the seller could not exercise the ROFR given to the buyer. One New York court noted that had the parties intended otherwise, “such could have been accomplished by the inclusion of the appropriate language.” *Sniezyk v. Stocker*, 188 Misc2d 582, 729 NYS2d 264 (Sup. Ct., Fulton Co., 2001).

Conclusion

The right of first refusal creates an incentive for a tenant to take better care of an owner’s property in the hope of future ownership. It also provides a valuable negotiating tool. A tenant may agree to pay a higher rent or make other concessions in exchange for the right of first refusal. However, the right of first refusal provides a barrier between the seller and an interested third party. A carefully drafted document will tend to resolve most of the disputed issues that are currently being litigated. As the courts will enforce whatever reasonable terms the parties themselves agree to include in an ROFR clause, practitioners who draft a proper right of first refusal will be much less prone to trigger unexpected litigation disputes over the meaning of their agreements.

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