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Right of First Refusal

In Pursuit of an Effective, Litigation-Proof Proviso

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Since biblical Abraham's purchase of his wife Sarah's burial plot in Hebron from Ephron the Hittite, the transfer of land has been creative, predictable and repetitive.¹ Despite the familiarity of such transactions, land transfers have been the subject of an inordinate amount of litigation. Of course, the importance and value of land and the necessity for shelter assists in explaining many of the battles.

However, an analysis and survey of right-of-first-refusal litigation, during the past quarter-century, provides a different conclusion— litigation has ensued mainly as a result of faulty draftsmanship, and disputes over the meaning of the clause in particular agreements. In fact, since 2001, 31 New York judicial decisions have been published involving a right of first refusal; 25 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.² This includes 24 cases decided on appeal.

To find further support for this theory, the interests of each of the parties provides more than a clue. The right of first refusal is one of those clauses in real estate that rarely breeds disagreement. First, the seller only transfers its land at its option. Second, the seller should never maintain a strong preference for a particular buyer as all potential buyers

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CONTRACT DRAFTING



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will be paying the same asking price. Unlike government-created turf wars such as succession battles or desires to increase rent in rent-regulated properties in landlord-tenant disputes, a transaction involving a holder of a right of first refusal includes two sides with mutual goals.

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 over right-of-first-refusal clauses.³

Background

The Right of First Refusal (ROFR) to purchase a parcel of real property is often included in real estate contracts and leases.

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 time.

Enforcing the Actual Terms

Upon receipt of a bona fide offer to purchase from a third-party,⁴ 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 or 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.⁵ “[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. [citations omitted].”⁶

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 one case where 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, but the owner’s final contract said that the mortgage would amortize over a 30-year period, this constituted a material variance from the accepted offer of sale, as 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.⁷

Likewise, 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, a buyer-right holder was granted specific performance. The court granted the buyer specific performance because the buyer accepted an offer to purchase a property for \$1,150,000 but did not make a simultaneous down payment of ten percent or \$115,000 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.⁸

Restraints on Alienation

Some ROFR clauses contain a pre-set 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 agreements very carefully. The price (or the formula the parties adopt to set the price) at the time they enter into their agreement may unreasonably undervalue the property at such time in the future when the ROFR is triggered by the then 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 that New York retains the common law

As the courts will enforce whatever reasonable terms the parties themselves agree to include, 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.

rule against unreasonable restraints on alienation and that invocation of the rule in the appropriate case will render an ROFR null and void and unenforceable.⁹ 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.¹⁰ The common law rule against unreasonable restraints on alienation is applicable to ROFR clauses contained in the by-laws of condominiums.¹¹ However, condominium ROFR’s are usually viewed as “beneficially related to the peculiar characteristics of condominium ownership.”¹² An ROFR “generally used in connection with condominium management” granting a condominium board the right to purchase, at the same price and terms, a unit offered for sale by an owner, “does not constitute an unreasonable restraint on the alienation of such unit” and “has been held to serve a valid interest.”¹³

Right of First Refusal, Draft

An ROFR provision may not violate either New York’s Rule Against Perpetuities or the common law rule against unreasonable restraints on alienation. The invocation of those rules in the appropriate case will render an ROFR null and void and unenforceable.¹⁴

As noted above, an 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. ROFR’s 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.¹⁵

The practitioner drafting an ROFR should require that the election to exercise the ROFR be completed within a narrow time frame, that the election be written, and that it be delivered by certified or other mail tracking device. A closing date scheduled a certain amount of days from delivery of the executed contract should be required, but only against the ROFR holder.

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 percent down payment within a short time (e.g. 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 financing contingency.¹⁶

The ROFR is already a deterrent to potential buyers who see the ROFR as an impediment to closing a deal, so these tight, 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.¹⁷

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 rejected.¹⁸ The agreement should include a provision that the ROFR is terminated on the day the lease ends to avoid unnecessary litigation.¹⁹

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 in which the seller is more than a half owner from the ROFR, 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.²⁰ In addition, unless written into the ROFR, courts will not allow the landlord a carte blanche menu of conditions added to the terms of the deal.²¹ Of course, by requiring the ROFR holder to execute the same contract and conditions as an interested third party, this will not become an issue.

Right of First Refusal, Deed

Attorneys need to be particularly careful in any transaction involving both a contract for the sale of real property, which contains an ROFR clause, and a deed for the sale that the parties intend to

contain the same ROFR. Where the ROFR in the deed inadvertently may 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.²²

Similarly, 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. Had the parties intended otherwise, “such could have been accomplished by the inclusion of the appropriate language.”²³

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 a ROFR clause,²⁴ 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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1. Genesis: Chapter 23.

2. The referenced data has been provided using numbers from the Lexis Nexis New York Real Estate Database. In 2001, five reported decisions were published opinions involving the right of first refusal; in 2002, two published decisions were reported; in 2003, six published decisions were reported; in 2004, seven published decisions were reported; in 2005, nine published decisions were reported; and in 2006, to date, two published decisions were reported.

3. Sometimes litigation will not spring from faulty drafting but from a buyer attempting to garner more

time to find the funds to make a purchase. See *Million Gold Realty Co., Inc. v. S.E. & K Corp.*, 4 AD3d 196, 772 NYS2d 271 (1st Dept. 2004).

4. A bona fide offer is a genuine outside offer that the seller is honestly willing to accept, and not one made solely to extract a more favorable purchase price from the right holder. See *Story v. Wood*, 166 AD2d 124 569 NYS2d 487 (3d Dept. 1991).

5. See, e.g., *M&A Motors, Inc. v. Disco Realty, Inc.*, 24 AD3d 519, 806 NYS2d 244 (2d Dept. 2005).

6. *Id.*

7. See *Danyluk v. Glashow*, 2 Misc3d 1005A, 784 NYS2d 919 (NYC Civ. Ct., NY County, 2004) (the owner in this case also attempted to change the terms of the deal by requiring the personal guarantee of the right holder and by adding a no-prepayment clause, neither of which were included in the original notice of the bona fide offer); see also *Jeremy’s Ale House Also, Inc. v. Jocelyn Luchnick Irrevocable Trust*, 22 AD3d 6, 798 NYS2d 416 (1st Dept. 2005) (concerning the peculiar effects of a “last right of refusal”).

8. See *Degree Sec. Sys., Inc. v. FAB Land Corp.*, 302 AD2d 555, 756 NYS2d 248 (2d Dept. 2003).

9. *Hermann v. AMD Realty, Inc.*, 1 Misc3d 586, 765 NYS2d 232 (Sup. Ct., Westchester Co., 2003), *aff’d*, 8 AD3d 619, 779 NYS2d 560 (2d Dept. 2004).

10. *Id.*

11. *Demchick v. 90 East End Ave. Condo.*, 18 AD3d 383, 796 NYS2d 62 (1st Dept. 2005) (citing *Anderson v. 50 East 72nd St. Condo.*, 119 AD2d 73, 505 NYS2d 101 (1st Dept. 1986)).

12. See *Anderson*, 505 NYS2d 101.

13. *Id.*; but see *Inwood Park Apartments, Inc. v. Coimmach Indus. Co.*, 6 Misc3d 246, 783 NYS2d 453 (Sup. Ct., NY Co., 2004), *aff’d*, 22 AD3d 350, 801 NYS2d 893 (1st Dept. 2005) (held lease agreement under which residential cooperative was effectively required, indefinitely, to retain the services of a laundry room services provider constituted unreasonable restraint on alienation of property).

14. See *Metro. Transp. Auth. v. Bruken Realty Corp.*, 67 NY2d 156, 163, 501 NYS2d 306, 309 (1986); see also *Wildenstein & Co. v. Wallis*, 79 NY2d 641, 584 NYS2d 753 (1992).

15. *Id.*; see also *Hermann*, 765 NYS2d 232 (the refusal right was an unreasonable and unenforceable restraint on the alienation of property).

16. See *Danyluk*, 784 NYS2d 919 (the terms of a mortgage are generally “held to be an essential and material elements of a contract”).

17. See *Jeremy’s Ale House Also, Inc.*, 798 NYS2d 416, 419 (party has a right to be provided with proof of a third party offer); see also *Danyluk*, 784 NYS2d 919.

18. See *M&A Motors, Inc.*, 806 NYS2d 244 (the right holder commenced an action for specific performance after defendant was no longer interested in selling the property); see also *LIN Broad. Corp. v. Metromedia, Inc.*, 74 NY2d 54, 60, 544 NYS2d 316, 319 (1989).

19. See *Hercules Corp. v. Monaco Equities*, 2006 NY Slip Op 50430U (NY Sup. Ct. 2006).

20. See *H.G. Fabric Discount v. Pomerantz*, 130 AD2d 712, 515 NYS2d 823 (2nd Dept. 1987) (offer was conditioned upon the tenant vacating the premises, and as the condition was impossible, the tenant was not required to exercise his right of first refusal as to that offer).

21. See *Danyluk*, 784 NYS2d 919.

22. See *Spiegel v. Rickey*, 285 AD2d 879, 727 NYS2d 549 (3d Dept. 2001).

23. *Sniezyk v. Stocker*, 188 Misc2d 582, 729 NYS2d 264 (Sup. Ct., Fulton Co., 2001); See also, *Tarallo v. Norstar Bank*, 144 Ad2d 157, 534 NYS2d 485 (3d Dept. 1988).

24. See *Concert Radio, Inc. v. GAF Corp.*, 108 AD2d 273, 488 NYS2d 696 (1st Dept. 1985), *aff’d*, 73 NY2d 76 (1988) (the requirements of the ROFR are determined by the terms of the agreement itself).

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