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Contractual Provisions

Rights of First Refusal

Traps for the Unwary (and the Wary)

Most real estate practitioners are familiar with rights of refusal provisions. They appear in the large majority of long-term ground leases and can often be found in commercial leases, joint venture agreements and many other common real estate instruments.

The core concept of a real property right of first refusal is relatively simple and straightforward: If the owner of real property or an interest therein has received an offer to purchase the property or interest (the "offered interest") that it wishes to accept, the holder of the right of first refusal has the right to buy it on the same terms offered by the third-party offeror. However, embedded within most ROFR provisions, even relatively well-drafted ones, are all sorts of traps and ambiguities, even when the owner makes best efforts to comply with the provision. This article details some of these traps and ambiguities and recommends ways to draft, and implement, the ROFR provision so as to reduce (but not completely eliminate) the uncertainties and litigation risk. (This article will not discuss "rights of first offer," another common type of provision pursuant to which the owner must first solicit an offer from the holder of the right before marketing the Offered Interest for sale.)

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1. The Trigger Event

Typically, the ROFR "trigger event" is an owner's "desire" or "intention" to accept an offer from a third-party to buy the offered interest. A well-drafted ROFR provision will require that the offer contain all of the "material" terms of the proposed sale, both to reduce the likelihood of a dispute with an ROFR holder as to what the terms of the sale are, and to prevent an ROFR holder from arguing that the "trigger event" has occurred, and that it can elect to buy the offered interest, where the owner receives nothing more than an expression of interest to purchase at a given price.

What if the owner wishes to sell the offered interest encumbered by an ROFR as part of a package with other properties or assets? Without language prohibiting the offer from being "conditioned upon the purchase of any other property or the consummation of any other transaction," there is no doubt that a desired sale as part of a multi-property transaction is a trigger event, but now the ambiguities and pitfalls become impossible to avoid. What are the terms that the ROFR holder must match? How can the purchase price be determined if the owner and third-party did not do a purchase price allocation when they agreed upon the terms of sale? Even if they did allocate, that allocation would arguably be subject to challenge on the grounds that the price for the subject property was made artificially high to prevent an ROFR exercise. Since there are no easy fixes to these ambiguities, a real estate owner whose properties may have their highest value when sold together (e.g., adjoining or otherwise complementary parcels) must be especially wary of granting ROFRs.

Other ambiguities with respect to the "trigger event" can usually be resolved with precise drafting. For example, the ROFR provision should make clear whether or not the provision applies to transfers of direct or indirect equity interests in the owner, and if so, whether it applies to transfers of controlling interests only. Transfers to affiliates, of course, should always be excluded, as should corporate restructurings, estate realignments and other transactions which don't reflect a true sale by the owner. From the ROFR holder's point of view, the ROFR provision should provide that the third-party offer must be for all-cash; otherwise, the ROFR holder may not be able to effectively match a transaction which reflects a property swap or which is tied to an

offer of financing for another deal. In fact, ROFR holders with enough leverage are often successful in having the ROFR provision contain language expressly excluding "any term or condition which is not reasonably practicable" for the ROFR holder to accept, although owners should beware that the possibilities for mischief with this provision are clear. Finally, because courts can have surprising and unpredictable views on the precise meaning of a "sale" versus a "transfer" versus "an assignment", a clear ROFR provision should provide that it applies with respect to any type of disposition of the Offered Interest.

2. Notifying the Holder.

In theory, if an owner receives a written offer that it wishes to accept and that it believes contains all of the material terms, the owner can immediately send notice of the offer to the ROFR holder, thereby starting the clock on the ROFR holder's right to accept those terms. Unless the third-party offeror insists on this course because it does not wish to spend the time or money negotiating an entire contract that is subject to an ROFR, this course of action is generally not advisable, as it may allow the ROFR holder to either claim the clock hasn't started because some of the material terms are missing, or accept the offer but then argue with the owner over the precise terms of the actual contract. The better course would be to negotiate a full-blown contract with the third-party, and then submit a copy of this contract to the ROFR holder to start the clock. Sometimes this may necessitate the negotiation of a break-up fee or other means of reimbursing the third-party offeror for its time and effort, but that may nevertheless be worthwhile. Even this course of action may be problematic if the written contract contains a due diligence period or other contingency, as the ROFR holder may allege that the clock doesn't start until all of those contingencies have been satisfied or waived.

Surprisingly, the owner's notification duty may not even end with the transmittal of a contract for the Offered Interest. There are court cases that suggest that if the ROFR holder requests clarification of the meaning of one of the terms of the offer or one of the provisions of the applicable contract, the owner is obligated to help the ROFR holder understand the provision.

3. Third-Party Offeror

Of course, it is essential that any acceptance of a third-party offer be made contingent on the ROFR holder electing not to exercise its ROFR. As noted above, it is common for third-party offerors to insist on a "break-up fee" if the ROFR is exercised. But the issues with third-party offerors can be much more complicated than that. Consider the following 2 scenarios.

Court cases suggest that if an ROFR holder requests clarification of the meaning of one of the terms of the offer, the owner is obligated to help the holder understand the provision.

a. An ROFR provision requires the ROFR holder to "match" at 105 percent of the purchase price offered by a third-party. (This is sometimes provided for at least partly on the justification that the owner needs the cushion to cover any break-up fees it has to pay to the third-party offeror.) The ROFR holder tells the owner that it will match at 103 percent, but not 105 percent. Can the owner accept this higher offer without giving the third-party a claim that it was entitled to rely on the 105 percent provision? There seem to be no cases addressing this point, and so the only effective protection for the owner is to give itself this right as part of the terms of the third-party offer.

b. An ROFR holder elects to "match" at 100 percent of the purchase price as required by the ROFR provision. At the closing, it alleges that there is some problem that gives it the right not to close, and tells the owner it will only close if it is given a 2 percent price reduction. Whether or not the owner believes there are valid grounds for the ROFR holder to walk away, it may believe the right business decision is to proceed with the closing at the reduced price rather than have a litigation over the deposit. Can the third-party offeror claim that its rights were violated because the ROFR holder's "match" was not real? Possibly — again there are no cases on point. In this case the owner is truly caught between a rock and a hard place.

4. Exercising the Right

In general, if the ROFR holder wishes to match, it must execute a contract identical to the third-party's offer. Courts will usually enforce this to the letter, even if the offer includes some type of unique, non-cash consideration, unless the ROFR provision expressly prohibits this. One often unintended consequence is that the ROFR holder receives certain benefits it may not be entitled to. Certain owner representations, indemnities and closing conditions that are part of the third-party offer may really not be fair for the ROFR holder to get if, for example, the ROFR holder is a triple net ground lessee of the Offered Interest and therefore knows more than the owner about property specific facts and circumstances, but unless the ROFR provision expressly says otherwise the ROFR holder will get the benefit of these rights when it elects to match the offer.

5. Termination of the Right

May the owner revoke a notification that an ROFR trigger event has occurred if, for whatever reason, the owner and the third-party offeror elect to terminate their deal? In New York the answer is yes if the ROFR holder has not yet elected to exercise its right, but the result may differ elsewhere.

As can be seen, ROFR provisions are much more complicated than they appear, and the real estate practitioner and his or her owner client should be wary of the potential ambiguities and pitfalls both before agreeing to grant such a right and before attempting to sell a real property interest encumbered by such right.