

TRANSACTIONAL REAL ESTATE

Exceptions in Rights Of First Refusal Provisions



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Right of first refusal (ROFR) provisions are frequently found in ground leases, joint venture agreements and other real estate agreements. In a typical ROFR provision, the parties agree that if one party receives a bona fide third-party offer to purchase the leased property or a joint venture interest, the holder of the ROFR must first be given the right to purchase the property or joint venture interest on the same terms. Certain scenarios—such as foreclosure sales, deeds in lieu of foreclosure, sales of the interest or property as part of a portfolio sale, or corporate transactions involving the transfer of direct or indirect interests in a landlord—are typically not intended (at least by the transferor) to trigger a ROFR but may inadvertently be captured by ROFR provisions that do not expressly

exclude them. These exceptions to a ROFR should be specifically considered by the parties in order to avoid any uncertainty that may arise when a property or joint venture interest is the subject of a transaction or other

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event that is not a single asset sale but arguably falls within the scope of the ROFR.¹

Involuntary Transfers

Parties have litigated over whether a sale upon a foreclosure or the delivery of a deed in lieu of foreclosure should trigger a ROFR. A transfer of the property does of course take

place, but courts have nonetheless held that a ROFR should not be triggered because the foreclosure does not occur in response to a bona fide offer and does not constitute a voluntary action by the owner to sell the property.

In *Huntington Natl. Bank v. Cornelius*,² the court held that a foreclosure sale did not trigger the right of first refusal held by a joint tenant pursuant to a joint tenancy agreement with the defendant mortgagor. The joint tenancy agreement provided that if either party subsequently acquired the interest of the other and thereafter intended to sell the property, the other party had a right of first refusal on the sale. The court held that the defendant did not offer the property for sale because the word “offer” was intended to cover a “conscious and voluntary choice by the owner to make the property available for sale.” A foreclosure, in contrast, is an involuntary process resulting in a forced sale where the referee, on behalf of the court, is the seller; it is

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not the volitional act of the owner. Moreover, the court stated that long-standing principles relating to rights of first refusal contemplate a willing seller who desires to part with the property, which was a circumstance clearly not present in this situation.

In *Tadros v. Middlebury Medical Center*,³ the court similarly found that the holder's ROFR was not triggered in the context of a foreclosure sale because the owner did not have any intent to sell the property and did not receive a bona fide, written offer. Rather, the owner was forced to act in accordance with a court order for the foreclosure of the property whereby the court-appointed committee was the seller of the property, not the property owner. The sale was clearly not voluntary and the court looked at the plain language of the real estate instrument in question to determine that the owner did not "form the intention" of selling nor did he accept a "bona fide, written offer" to sell the property.

If an exception for involuntary transfers is not specifically included in the ROFR provision, the lender would still likely be protected based on the relevant case law as well as the plain language of most ROFR provisions. However, practitioners often include this exception when drafting the exclusions to a ROFR provision in order to provide comfort for any existing or future lender and to avoid any potential disputes between the parties. Also, the rationale for the decisions in these cases makes it less clear that transfers in lieu of foreclosure would be viewed similarly by

the courts,⁴ so a transfer in lieu of foreclosure (which is often consummated less as a voluntary sale and more as a faster and less expensive path to the inevitable result) should be expressly excluded.

Lenders would also prefer that a ROFR be permanently extinguished after the occurrence of a foreclosure or a deed in lieu of foreclosure, as the lender may view the continuing ROFR as an encumbrance that will impact the ultimate realization on its collateral; however, this concern can often be adequately addressed by adding an exclusion for the first subsequent transfer by the lender or lender's designee after the foreclosure event. This compromise offers some comfort to the lender and also permits the tenant to maintain its previously bargained-for ROFR after a foreclosure event.

Portfolio Sales

When a property that is subject to a lease containing a ROFR is included as part of a larger portfolio sale of the landlord's assets, the transaction would clearly trigger the ROFR absent a specified exception.⁵ This scenario raises a number of different issues that the parties should address during their negotiation of the ROFR provision. If the parties wish to include such a sale within the ROFR, they should include language prescribing how the purchase price is to be determined in the event the buyer and seller in the sale transaction have not allocated a portion of the purchase price to each individual property (even if there is such an

allocation, the holder of the ROFR may wish to provide for a specified mechanism to determine the allocated purchase price in order to prevent the seller from assigning an artificially high price to the property subject to the ROFR). In some cases, the purchaser may be paying a premium for purchasing an assemblage of properties. In that event, if the parties were to allocate based on the purchase price of the larger transaction, the allocated amount for the property subject to the ROFR may be artificially inflated.

If the property subject to the ROFR is likely to be vital to the value of a transaction, the property owner may wish to exclude portfolio sales entirely from the scope of the ROFR. From the ROFR holder's perspective, adding an exception for portfolio transactions would be more palatable if it included a qualification that any transaction that falls under this exception must be for a legitimate business reason and cannot be for the sole purpose of circumventing the ROFR.

For example, if the ROFR does not apply to a sale of the property together with "material other assets," a property owner who wishes to sell a property without triggering the ROFR could include an immaterial additional parcel of real property or even a substantial amount of personal property in a sale in order to fall within the exception and avoid triggering the ROFR. Such a result would be mitigated by including a threshold for

a certain number or percentage of properties that would need to be included in the larger sale transaction in order to qualify under a portfolio sale exception.

Transfers of Interests

If a ROFR does not in some manner restrict the sale of equity interests in a landlord or joint venture partner, the ROFR holder's bargained-for rights can easily be circumvented. Consequently, ROFR provisions are often triggered by a sale of equity interests in the landlord or joint venture partner (which we refer to as a "restricted party"). This is particularly appropriate when the restricted party is a single-purpose entity.

However, the application of a ROFR to the sale of equity interests in the restricted party can result in unintended consequences. The ROFR provision has to be specifically tailored so that it protects the interest that the tenant or joint venture partner is trying to protect (such as having the opportunity to acquire the property or protecting against having an undesirable landlord or joint venture partner), while not placing an undue burden on broader transactions undertaken by or with respect to the restricted party.

One obvious point is that the ROFR should not be triggered by just any transfer of equity interests, but at a minimum by a transfer of a controlling interest. A restricted party could be a company with publicly traded stock, for example, and a ROFR should not be triggered each time the stock trades. Also, the parent of a restricted party should be permitted

to bring in additional equity holders or to transfer a minority interest in the restricted party without triggering a ROFR (although in the case of additional equity holders, it may be appropriate to give the other party pre-emptive rights so then it can participate in the transaction).

Given the breadth of the definition of "transfer" in some transaction documents, a ROFR could even be triggered by a pledge of indirect equity interests. Burdening these types of transactions with a ROFR is not necessary to

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protect the interest of the tenant or joint venture partner and would typically be inconsistent with the parties' intentions in providing for the ROFR.

In some cases, a restricted party may not be a single-purpose entity and may own significant assets in addition to the subject property. The tenant or joint venture partner did not bargain for the right to acquire the additional assets owned by the restricted party. A ROFR provision that is triggered by a sale of all of the equity interests in the restricted party, unless properly drafted, may be triggered by a corporate-level transaction (such as a stock sale or

merger) even if the restricted party owns a portfolio of assets.

However, as in the case of portfolio asset sales, ROFR provisions incorporating a carve-out for corporate-level transactions that are not carefully crafted can have the effect of permitting a restricted party to circumvent the ROFR. Typically, parties harmonize this conflict by providing an exception to the application of a ROFR to a corporate-level transaction only where the restricted party owns substantial additional assets other than the property or properties subject to the lease or joint venture. For example, if the assets subject to the lease or joint venture are more than an agreed percentage (by value or other agreed metric) of the total assets of the restricted party, then the ROFR would apply to a corporate-level transaction of direct or indirect interests in the restricted party.



1. Other types of transactions not the subject of this article, such as transfers to affiliates, transfers for estate planning purposes, gifts and donations and transfers as a result of a condemnation, are customarily excluded from ROFR provisions as well.

2. 80 A.D.3d 245 (N.Y. App. Div. 3d Dept. 2010).

3. 263 Conn. 235 (Conn. 2003).

4. See, e.g., *Pellandini v. Valadao*, 113 Cal. App. 4th 1315 (2003).

5. The portfolio exception would also be applicable in the context of the sale of a joint venture interest.