

Negotiating and Exercising Rights of First Refusal

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Including a Right of First Refusal (ROFR) provision in a lease or other real estate contract is significant since a holder of such ROFR has essentially locked in a future right to exercise an option to purchase the property and, thus, protect its investment in the real estate, including all physical improvements and any goodwill developed relating to the site.

Under an ROFR, the owner of the property agrees in advance that if, in the future, it decides to sell the property, the holder of the ROFR has the first right to accept or reject any such offer.

When a holder receives an offer, what steps should it and its counsel take? What are the terms of the offer, and is the holder bound by the same terms? If the holder is amenable to the sale price but is unwilling to accept other nonmonetary terms in the offer (i.e., limitations of remedies), can the holder negotiate more acceptable terms? How does the holder accept the offer and can the holder rescind its acceptance if it reconsiders? If the thwarted third-party buyer claims that its offer was not the one accepted by a holder or any other such breach and sues the seller and holder, what is the likelihood that the transaction will be prevented? What are the potential litigation costs? Could the holder or seller be liable for monetary damages?

The ease of navigating through the myriad issues that may arise with an ROFR will largely depend on the original negotiations of the right and the final ROFR terms that the seller and holder agreed to in advance. Because the terms of the ROFR will govern the offer, it is important to negotiate the terms of the right with an eye to the future, ensuring that the holder's specific requirements are incorporated into the ROFR itself. If the ROFR provision did not include specific terms or parameters when initially negotiated, the holder may have to consider an offer with terms that the holder finds unfavorable. In this case, the holder may have to decide between an imperfect offer and no transaction at all.

Beyond the original negotiations, the holder's attorneys can also provide significant value when an offer is tendered to the holder. The attorneys can help the holder evaluate the offer and ensure that the ROFR is properly exercised. While negotiating the final provisions after exercising the ROFR, the holder and its counsel need to keep in mind the threat of litigation with the seller or any third party, particularly if material changes are made to the offer.

Understanding the Offer

Before the holder can decide whether it wants to exercise the ROFR, it must understand what the terms of the offer actually are. The answer will depend greatly on whether the seller and third party have negotiated a term sheet or a full contract, and whether the ROFR included specific pre-negotiated terms.

An offer in the form of a term sheet gives the holder of an ROFR more flexibility and room to negotiate terms that are more suitable to the holder, as opposed to an offer in the form of a fully negotiated contract, which will force the holder to accept the pre-negotiated terms in that contract. For this reason, the holder should try to negotiate in the original

ROFR provision the requirement that the seller only provide a term sheet as the offer. Sometimes, however, it is more practical and cost-effective for the seller to negotiate a complete contract with the third party before submitting the offer to the holder, especially if, for example, the property is part of a portfolio and the seller is negotiating the sale of many parcels of real estate that include the property with the ROFR.

Moreover, the seller may wish to simply retain leverage over the holder of the ROFR. For example, in some situations, the seller might later prefer to sell to a specific third party and a full contract might act as a deterrent to the holder, increasing the likelihood of closing with the preferred buyer. For these reasons, the seller may refuse to include such a provision.

As noted above, the contours of the offer will also depend on the provisions of the ROFR itself, illustrating the importance of the original negotiations. If the ROFR provides that the holder's right to purchase the property is on commercially similar terms to any offer, then the holder will have much more flexibility in its later negotiations with the seller than if the ROFR provides that the right to purchase is on the same terms as any offer.

The initial negotiation of an ROFR provision provides an opportunity to lock in certain provisions or terms by stating that those provisions will govern irrespective of the specific terms in the third party's offer. Such carve-outs can include confidentiality provisions, indemnity provisions, acceptable encumbrances on title, a party's responsibility with respect to broker fees and closing costs, and required closing documentation. Furthermore, the ROFR may also specify, inter alia, certain limitations on remedies or provide for certain representations in advance. Although the seller may object to including these carve-outs in the ROFR, if it is important that the holder have any of these provisions, then these provisions should be discussed in the original negotiations so that they could be ultimately included in the ROFR.

If drafted properly, the ROFR should also have addressed certain contingencies related to the offer. The ROFR should provide a method to determine a purchase price for the property if the proposal contemplates the sale of multiple parcels, such as an appraisal or a predetermined formula. Similarly, the ROFR should provide a method to value noncash consideration. By negotiating and setting these terms in the ROFR, the holder's attorneys can eliminate some ambiguities in advance and possibly avoid future disputes. If these provisions are not included in advance, the holder and seller may disagree on how to allocate the purchase price or value the non-cash consideration, leading to a failed transaction or even litigation.

Additionally, if the holder's contractual right is a last right of first refusal, then the seller has the ability to use the holder as a stalking horse. See *Jeremy's Ale House Also v. The Joselyn Luchnick Irrevocable Trust*, 22 A.D.3d 6, 8 (1st Dept. 2005). Again, the negotiation of the original terms of the holder's rights determines the nature of the subsequent offer, so the holder's attorney should take appropriate steps to avoid these risks.

Exercising the ROFR

Once the holder understands the terms of the offer, it can properly evaluate whether it wants to exercise the ROFR. Assuming the holder chooses to move forward, how should it actually exercise the right? As before, the terms of the ROFR will govern, including any deadlines or notice requirements.

The notice and other exercise requirements applicable to the ROFR should be strictly followed. Although failure to strictly comply with these provisions may be excused in some instances, cf. *Pitkin Seafood v. Pitrock Realty*, 146 A.D.2d 618, 619 (2d Dept. 1989) (holding that deficiencies in tenant's imperfect exercise of option to purchase would be disregarded and compelling landlord to specifically perform the contract because the tenant had made substantial improvements to the property and the landlord was not prejudiced by the deficient exercise), complying with such requirements will avoid the risk of a dispute. At the very least, any dispute will add costs.

The ROFR should clearly provide the time period the holder has to exercise the ROFR. In negotiating the ROFR, the holder needs to consider how much time it will need to evaluate an offer, taking into account its internal processes, particularly if it is a large company that may require multiple internal parties to review and approve the exercise of the offer. That said, the seller will not want to provide the holder with too much time to make a decision, since delays may affect the seller's transaction and negotiations with the third party. The holder and its attorneys, on the other hand, should attempt to obtain as long a period as possible.

If the holder is certain that it wants to exercise the ROFR, it should notify the seller of its exercise as soon as possible because the seller normally has the ability to withdraw its offer before the holder accepts unless the ROFR specifically provides that the offer must remain open for a certain amount of time. See *LIN Broadcasting v. Metromedia*, 74 N.Y.2d 54, 62-65 (1989). Again, if the holder wants this or other provisions, then it must negotiate for them in the ROFR.

Post-Exercise of ROFR

As an initial matter, it is important to note that the exercise and acceptance of an offer by the holder creates a binding contract. See *Cipriano v. Glen Cove Lodge #1458, B.P.O.E.*, 1 N.Y.3d 53, 59 (2003); see also *Danyluk v. Jonathan L. Glashow, M.D.*, 2 Misc. 3d 1005A, 2004 N.Y. Misc. LEXIS 217, at *9-10, 21-22 (Civ. Ct. N.Y. Cty. 2004) (noting that the exercise of the ROFR created a binding contract and that material deviations from this contract constituted the breach thereof). Even while a more complete contract is being negotiated, the parties need to recognize that they are contractually bound to each other from the time of the offer's acceptance, and that any attempt to rescind the offer could be considered a breach of this contract.

However, from a practical standpoint, an arrangement may be possible if both the seller and the third party still want to proceed. The holder's attorneys must approach these discussions delicately because the risk of breach is real, and the seller could bring an action against the holder as a result, seeking damages from the breach, including liquidated damages (i.e., the deposit) if provided in the offer.

Assuming that the holder still desires to proceed, to what extent can it negotiate the details and the specifics of the purchase? The flexibility in the negotiations will depend on several factors. First, if the offer consisted of a term sheet as opposed to a fully negotiated contract, then the details must necessarily be negotiated (within the limits of the term sheet). Second, if the ROFR provided that the right to purchase would be on commercially similar terms as opposed to on the same terms, then the holder and the seller have more flexibility to alter the contract.

However, even with this flexibility, the seller and holder and their attorneys may be reluctant to make major changes because there is a risk of litigation with the third party over whether the new terms are commercially similar. Even if the seller and the holder prevail in such litigation, the inevitable costs may act as a deterrent to major changes.

Even if the offer consists of a fully negotiated contract and the ROFR provides for the right to purchase on the same terms as any offer, the holder and the seller will still have the ability to make non-material changes. What is considered 'material'? Certainly, any provision affecting the financial terms would be considered material and could not be changed. In *Danyluk*, the court found that alterations to the amortization period of a purchase money mortgage and the addition of a personal guarantee were material changes. 2 Misc. 3d 1005A at 12-17. In other contexts, courts have found the following terms were material: caps on sellers' liability for attempting to eliminate title defects, see, e.g., *Mehlman v. 592-600 Union Ave.*, 46 A.D.3d 338, 342-43 (1st Dept. 2007); limitations on buyers' remedies for sellers' defaults, see, e.g., *Gindi v. Intertrade Internationale*, 50 A.D.3d 575, 576 (1st Dept. 2008); provisions prohibiting purchase price abatements, offsets, and consequential or lost profit damages, see, e.g., *101123 LLC v. Solis Realty*, 23 A.D.3d 107, 108, 113 (1st Dept. 2005); and election of remedies provisions, see, e.g., *H Eighth Ave. Assoc. v. Stessa*, 92 A.D.3d 592, 593 (1st Dept. 2012). Other terms, such as representations and warranties, may also be material.

For the foregoing reasons, the seller's attorneys may be particularly hesitant to alter *any* terms when the offer involves a fully negotiated contract with the third party. The holder's attorneys must proceed delicately and manage their client's expectations. Any attempts at negotiation by the holder should be pursued with the understanding that it cannot push to the same extent as a normal purchase agreement negotiation. In the end, the holder may have to settle for terms that it would prefer excluded. This possibility reinforces the importance of the ROFR negotiation and understanding the offer before exercising the ROFR. Practically speaking, the holder should have made the decision that it is completely comfortable with the fully negotiated contract prior to exercising the ROFR.

If the third party does initiate a lawsuit related to negotiated changes in the offer, what form will the action likely take, and what analysis will a New York court perform? The third party may bring an action against the seller for breach of contract and other claims and against the holder for tortious interference. Despite the above discussion regarding the contractual restrictions and the limited flexibility of the seller and the holder, New York courts will most likely not strictly enforce these limitations for the benefit of the third party. Rather, in analyzing the third party's claims against the seller, the court will determine whether "the total substantive value of the [holder's] offer was at least equivalent, if not better, than what [the seller] would have received from [the third party]." *Montaperto v. Liu*, 2009 N.Y. Misc. LEXIS 6261, at *9 (Sup. Ct. N.Y. Cty. 2009); see also *Salm v. Sammito*, 111 A.D.2d 844, 845 (2d Dept. 1985); *34th & 7th Ave. v. 152 W. 34th St.*, 269 A.D.2d 153, 154 (1st Dept. 2000). If the total substantive value is equivalent, then the third party's action against both the seller and the holder will fail. See *Montaperto*, 2009 N.Y. Misc. LEXIS 6261 at *11-12. However, even if the seller and holder escape liability to the third party, they will have to incur legal fees to defend the action, increasing the overall cost of the transaction.

Conclusion

When negotiating an ROFR provision in a lease or other real estate contract, a practitioner needs to help guide its client to think about the future and help it protect its investment in the property. If the holder and its attorneys do

not consider the issues related to effectively exercising an ROFR and account for the risks of potential litigation claims if not exercised within any limitations imposed, then the holder may be faced with a costly path that could ultimately cost the client the right to acquire the property. However, a well-thought-out ROFR provision, along with proper guidance on limiting the risks of litigation, will help a practitioner shape its client's future.

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