Issues to Consider in Rights of First Refusal

People often talk about giving or getting a Right of First Refusal ("ROFR") in real estate transactions. But what is a ROFR? A simple definition might be:

If the owner of the property decides to sell the property, then the person holding the ROFR gets the opportunity to buy the property on the same terms first.

That definition is simple and seems straightforward, but there are potential problems in that simplicity for both the party giving and the party getting the ROFR. Fortunately, many of the potential problems may be avoided by recognizing and addressing them while both parties are working together to agree on the terms of the ROFR.

Let's talk about some of the issues you should consider when you are giving or getting a ROFR.

**Property Covered**

What property is covered by the ROFR? Although this usually is not a problem, the ROFR should specify precisely what real property is to be covered by the ROFR ("Property"). Lack of clarity in the description of the Property could be detrimental to both the owner and the ROFR holder.

Assuming the Property is described properly in the ROFR, what rules apply if the owner decides to sell the Property as part of a package with other property? For example, what if the owner plans to sell the Property as part of a shopping center, a larger tract, or a group of similar properties? Does the ROFR holder have the right to make the owner break out the Property and offer the Property separately to the ROFR holder?

While requiring the owner to break out the Property from the larger sale may sound fair at first blush, it may prevent the owner from being able to sell the other property. The owner's desire to sell the other property also will make it more attractive for the owner to collude with the third party buyer to make the terms of the sale of only the Property unattractive to the ROFR holder. For example, the owner might impose a restriction on the use of the Property that would make the Property unusable for the ROFR holder's purpose while not affecting the third party buyer's proposed use.

While there is no solution that is fair to all parties, by recognizing the issue at the beginning, the parties can structure the ROFR so neither party feels it is being taken advantage of if the situation does arise.

**Selling the Owner Instead of the Property**
Whenever the owner of the Property is an entity (such as a corporation or a limited liability company), the parties should ask this question: Does the sale of the stock in the corporate owner or the sale of the membership interests in the limited liability company owner trigger the ROFR?

If the main asset that the entity owns is the Property, then the ROFR should provide that the sale or transfer of the stock or membership interests in the entity is considered a sale or transfer of the Property that triggers the ROFR. Otherwise, the owner may thwart the ROFR by “selling” the company instead of the Property.

**Transfers Covered**

ROFR language often states that “any sale or transfer” of the Property will trigger the ROFR, but the parties rarely intend for every transfer to trigger the ROFR.

For example:

- Most owners do not expect to trigger the ROFR by giving their lender a lien (such as a deed of trust) on the Property even though the lien technically may involve a transfer of legal title to the lender.
- Likewise, most owners do not intend for the ROFR to prevent them from making transfers to family members or trusts for estate planning purposes.
- Similarly, an entity owner rarely expects a merger with another company to trigger the ROFR (subject to the exception mentioned above).

Transfers such as these examples can be excluded from the definition of a sale or transfer otherwise subject to the ROFR without significantly impacting the ROFR holder's rights by providing that the “new” owner also will be subject to the ROFR.

To reduce the risk of the owner's future lender objecting to a ROFR, the owner may want to specify in the ROFR that granting a deed of trust on the Property will not be a sale or transfer of the Property subject to the ROFR and that any foreclosure of the deed of trust likewise will not be subject to the ROFR.

To protect the ROFR holder's rights, the ROFR holder may want to specify in the ROFR that, although the use of the Property as collateral and any foreclosure will not trigger the ROFR, the purchaser of the Property at a foreclosure sale will be subject to the ROFR with respect to a future sale of the Property.

**Same Terms**

When the ROFR refers to "on the same terms," do the parties really mean the exact same terms? While the wording may sound fair, it can put the ROFR holder in a difficult or impossible position.

For example, if the owner proposes to do a land swap, the ROFR holder may be unable to fulfill the "same terms" requirement. If the ROFR holder thinks that a land swap might occur, then the ROFR holder may want to add language to address that situation. One possibility would be to provide that if the owner proposes to do a land swap, then the ROFR holder may require that the "purchase price" for the Property be converted into a dollar amount based on a fair market value appraisal of the Property or the land to be acquired in the swap.

While the concept underlying a ROFR is that a seller doesn’t care who pays the purchase price as long as the seller receives it, there often are other forces in play that may make an owner favor a third party purchaser over a ROFR holder. It is important to remember that the terms of the ROFR generally will not come into play unless the owner already has "cut a deal" (at least tentatively) with a third party. Consequently, the ROFR holder must make sure that the "deal" the owner cuts is not done in a way that will reduce the ROFR holder's rights.
For example, what would happen if an owner proposes to place terms in the sale that would be detrimental to the ROFR holder (such as a restriction prohibiting the Property from being used for the ROFR holder's business) but that would not injure or impact the value of the Property to the third party buyer? To prevent this from occurring, the ROFR holder may want to make sure that the ROFR provides that the Property will be sold to the ROFR holder subject only to the restrictions in place when the ROFR is signed regardless of what a future third party offer may say.

Similarly, if the ROFR holder is not in possession of the Property, the holder may want to make sure that it has the right to inspect the Property regardless of what the third party offer may state. When the ROFR terms are being discussed, the owner generally will agree to give the ROFR holder a limited inspection period regardless of what a future third party offer may provide.

Other issues that the ROFR holder may want to address are the type of deed the holder is to receive and the timeline for the closing if the holder accepts the offer. Specifying these items in the ROFR will protect the holder from being forced to accept a quitclaim or non-warranty deed from an owner or to close the transaction under an unrealistic schedule.

These issues can be addressed in the ROFR by providing that "notwithstanding the provisions of the third party offer" the following terms will govern with respect to the restrictions, inspection rights, deed warranties, and closing schedule. Failing to address these issues in the ROFR may give an owner the ability to structure a deal with the third party that makes it difficult for the ROFR holder to purchase the Property.

**Duration**

The duration of the ROFR should be stated in the ROFR. Generally, this is not a problem because both parties have a specific timeline in mind when they are negotiating the ROFR. However, there are times when the duration of the ROFR can be ambiguous unless care is taken to recognize potential ambiguities.

Ambiguous provisions often show up in leases where the tenant is to have a ROFR to purchase the leased property. The ambiguous language often reads something like: "During the term of this Lease, the Tenant will have a ROFR on the Leased Premises."

Does that sentence mean that the tenant will have a ROFR each and every time that the Property is offered for sale during the term of the lease? Or is the intention of the parties for the tenant to have just one right to purchase the property that applies only to the first sale of the Property and no others?

As with the other issues, the key to answering this question is to state in the ROFR whether it is an ongoing right (as is often the case in lease situations) or a one-time right that goes away if it is not exercised when the first sale occurs.

There are other issues to consider when a party wants a ROFR to last for an extended duration, but those are best left for future discussions.

**Notice**

How does the owner notify the ROFR holder that the owner has received an offer to purchase the Property from a third party that the owner will accept? While many of the prior issues are more important to the ROFR holder than the owner, the notice provisions are vital to the owner.

Today's technology allows us to locate people easier than ever before. However, it doesn't always work. Putting specific notice provisions in the ROFR can avoid countless questions about whether the notice was valid, whether it was received, and what to do when the ROFR holder cannot be located.
Substantial time and trouble may be avoided by specifying in the ROFR:

- The official notice address for the ROFR holder;
- The obligation of the ROFR holder to notify the owner of any change in the holder’s address;
- The delivery method to be used for the notice;
- The length of time that the ROFR holder has to respond to the notice;
- What the ROFR holder must do to accept the offer; and,
- What (if anything) the ROFR holder must do if the ROFR holder does not accept the offer.

Obligating the ROFR holder to keep the owner informed of the holder’s notice address places the burden on the party that actually has that information. Likewise, specifying the approved methods of delivery in the ROFR avoids claims by the ROFR holder that the delivery method selected by the owner was ineffective or invalid.

The owner also may want to put in a provision obligating the ROFR holder to sign a recordable document acknowledging that the holder did not exercise its right to purchase the Property. Provisions like this help avoid lingering questions about whether the notice was received and was sufficient, and help to keep the title to the Property “clean.”

The ROFR also should state what has to be in the notice regarding the third party offer for the notice to be valid. The parties may agree that the owner only needs to give the ROFR holder the main terms (such as price, deposit, inspection period, and closing date) to start the process.

Alternatively, the ROFR may require that a complete copy of the proposed agreement with the third party purchaser be provided to the ROFR holder. While providing the entire agreement has many benefits, it can create delays due to the owner and the third party buyer being required to expend time to negotiate a complete agreement for the transaction, something a third party buyer may not want to do if it believes the deal may be taken away by the ROFR holder.

The agreement also may contain information about the third party buyer's plans that it would prefer not be revealed to the ROFR holder.

Providing in the ROFR the specific basic provisions that must be included in the notice to the ROFR holder (and that a copy of the entire agreement is not required) will help the owner move the sale along without materially affecting the ROFR holder's rights.

On a side note, when dealing with an existing ROFR, it is important to read all of the provisions of the ROFR so that nothing is missed in the rush to send out the notice to the ROFR holder. Neither an owner nor a third party buyer wants to find out there is a question about the validity of the notice given to the ROFR holder.

**Change in Terms**

With larger transactions, there often are situations where the terms of the deal must change to accommodate reality. If the ROFR is written to provide that the ROFR holder must be given a copy of the exact terms, any change in the deal could result in ROFR holder being entitled to a new notice and a renewed right to purchase the Property.

To address such situations, an owner may want to require the ROFR to allow for limited variances in the price and timelines of the contract with the third party buyer without the ROFR holder's rights being triggered anew. Although negotiating those provisions at the beginning may not be easy, it always is easier to negotiate them before the parties are facing an actual situation and each party already has a specific result in
mind.

**Conclusion**

While all agreements are subject to disputes, considering and addressing some of the many issues that may come up in the future will help keep you on the "right" path when you are negotiating a Right of First Refusal. Consultation with an attorney experienced in Rights of First Refusal while negotiating one is preferable to having to employ one to try to save a subsequent deal.

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