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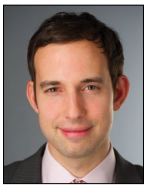
Expert Analysis

Challenges to Rights of First Refusal in New York Courts



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Rights of first refusal (ROFRs) are frequently drafted into real estate contracts and other agreements to give a party a preemptive right to purchase a property—a ROFR typically provides that, before the property is sold to a third party, the grantor of the right will first give the holder of the right a chance to buy the property at the price contained in a bona fide offer that the owner intends to accept.

As New York courts have seen challenges to the exercise and enforcement of ROFRs, certain patterns have emerged from the jurisprudence that can inform and improve the future drafting of ROFRs. The overarching theme is that the language of ROFRs will be scrutinized and strictly construed (given that a ROFR is an encumbrance on the grantor's alienation of the property), which underscores that the drafting is critical. Any such right should be drafted in as much detail as possible, so that the parties are bound to their intent as evidenced by the specific language of the contract and so that little if anything is left to be disputed between them later.

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A review of ROFR challenges in New York illustrates that courts honor the written intentions of the parties to a ROFR, but uncovers another pattern: courts will fill gaps in drafting with certain default rules and will look for certain indicators of reasonableness. Specificity and clarity in drafting a ROFR are necessary when trying to overcome a default rule or concern.

Describing the ROFR

New York courts have given great weight to the express language of ROFRs in the agreement at issue. The courts have typically declined to read anything further into the written description of the right to expand or enlarge the right. In *LIN Broad. Corp. v. Metromedia, Inc.*, 74 N.Y.2d 54, 542 N.E.2d 629 (1989), one party argued that the ROFR for certain ownership shares given to it under joint venture agreements was irrevocable during the specified ROFR period (even after the third-party transaction was abandoned).

The court, after considering the rights available to the drafting parties, found that irrevocability during the specified period was characteristic of an option, while the parties had described the right bestowed as a ROFR (and the ROFR is no longer exercisable if the underlying offer is withdrawn before the ROFR is exercised). The court opined that it would not require the selling party to go beyond its "promised performance" under the agreement and refused to "giv[e] the first refusal offer all of the attributes of an option." The court, in declining to go beyond what the parties had expressly bargained for, emphasized that there was nothing preventing parties from drafting irrevocability into an agreement if that is their intent.

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Further, when the right is labeled one way but described in another (e.g., the

right is called an "option" but bestows all the characteristics of a ROFR), the court will not read any additional characteristics of the label into the right as drafted. The court in *Metro. Transp. Auth. v. Bruken Realty Corp.,* 67 N.Y.2d 156, 492 N.E.2d 379 (1986) contended in dicta that a right which was labeled an "option agreement" but described as a right to purchase certain lots at market value if the Metropolitan Transportation Authority determined that the property was not necessary for its operations was in fact a ROFR as the provision did not permit the grantee of the right to "compel an unwilling owner to sell." Because a statutory rule that applied to options would not apply in this case to void the ROFR (even though it was labeled an option), the description of the right in the agreement became critical in its enforcement.

Naming the Parties, Defining the Parcel

New York courts have opted to enforce ROFRs only with regard to the parties and the parcel as they are named and described in the agreement. The court in *Gilmore v. Jordan*, 132 A.D.3d 1379, 17 N.Y.S.3d 545 (2015) examined a ROFR for a 29 acre parcel that was first drafted into a purchase and sale agreement for an adjacent 71 acre parcel (which expressly bound heirs and assigns) and then documented in the subsequent warranty deed conveying the 71 acre parcel (which did not expressly bind heirs and assigns).

The court found that because the parties had not expressly noted in the operative agreement that the ROFR was intended to bind the grantor's heirs and assigns, the right was "a personal agreement [between the parties], binding on themselves only." Even though the purchase and sale agreement stated that the right was to bind the heirs and assigns of the grantor, the court found that the right was extinguished upon the death of the grantor. Each agreement between parties granting a ROFR should then make expressly clear what parties are to be bound by it.

Additionally, a ROFR is likely to be enforced only as to the premises that are defined and demarcated in the agreement. The court in *Rome Sav. Bank v. B.W. Husted & Son, Inc.*, 171 A.D.2d 1048, 569 N.Y.S.2d 236 (1991) found that, when a ROFR covered 0.11 acres in a larger 1.6 acre parcel that the grantor wanted to sell, the holder of the ROFR could not exercise it for any portion of the property outside of the 0.11 acre parcel of land the ROFR covered. The court stated broadly that an "optionee's first refusal rights are governed by the property description contained in the option contract and are not enlarged by the fact that the landowner has considered selling, or has sold, a larger parcel of which the optioned land forms only a part."

Further, in *Foye v. Parker*, 15 A.D.3d 907, 790 N.Y.S.2d 787 (2005), the court found that a party holding an option (it is more than likely such a case involving a ROFR would have the same outcome) could not exercise its option with respect to a portion of the property described in the agreement (even when the purchase price was set at the same price per acre). The courts did not extend flexibility to the holders of these preemptive rights to either enlarge or reduce the parcels as described. Any flexibility desired by the parties should be drafted into the agreement.

Non-"Sale" Transactions

New York courts have found that ROFRs drafted to apply to "sales" of a subject property do not generally extend to stock sales, mergers, foreclosures, and other similar transactions. In *Torrey Delivery, Inc. v. Chautauqua Truck Sales & Serv., Inc.*, 47 A.D.2d 279, 366 N.Y.S.2d 506 (1975), the court found that neither a sale of the stock in the entity owning only the property (and no other assets) nor a subsequent corporate merger and reorganization constituted a "proposed sale" triggering a ROFR, even when a warranty deed transferring the premises to the surviving corporation was executed and recorded.

The court reasoned that the sale of stock in the corporate landlord did not operate to transfer the ownership of its property, the corporate merger did not entail any separation or divestment of that property from the corporate landlord, and, perhaps most importantly, the conveyance was "merely an explicit recording of what had already happened" as title to the premises vested in the surviving corporation by operation of law when the merger was effective. This case makes clear that if a ROFR is not drafted to include the sale of equity interests in the grantor or a corporate merger, the rights of a ROFR holder can be circumvented.

The court in *Huntington Nat. Bank v. Cornelius,* 80 A.D.3d 245, 914 N.Y.S.2d 327 (2010) found that a judicial foreclosure sale did not trigger the plaintiff's ROFR because the right was to be triggered when the subject parcel was "offer[ed] for sale", which conveys a "conscious and voluntary choice." Conversely, a foreclosure is an "involuntary process resulting in a forced sale." This conclusion comports with the general rule that the effect of a ROFR is to bind a party who desires to sell, while foreclosures are involuntary and the sellers are likely unwilling.

The court in *Huntington Natl. Bank v. Cornelius* did open the door for parties to include a foreclosure or an involuntary sale as a ROFR trigger: "[d]ifferent language in an agreement may well create such right." While perhaps not necessary in light of the *Huntington Natl. Bank* holding, many ROFR provisions explicitly exclude foreclosure sale as a trigger.

Subsequent Sales and Revocation

New York courts tend not to enforce ROFRs in connection with subsequent

sales after the holder of the ROFR declined to exercise the right in the first sale. Additionally, the courts have typically not found a ROFR to be exercisable, even during the time period when it was intended to apply, if the grantor of the right has removed the property from the market or no longer has an active deal to sell the property.

The court in *McPeady & Co. Inc. v. Chestnut St. Properties Inc.*, 179 A.D.2d 915, 578 N.Y.S.2d 711 (1992) found that a plaintiff who declined in writing to exercise his ROFR could not choose to exercise the right during a subsequent sale because a ROFR does not revive with respect to each sale involving the subject property. The court did note that the parties could have created a ROFR that applied with respect to every sale during a certain period of time by using appropriate language, but the language here did not create such a right.

Further, in *M & A Motors, Inc. v. Disco Realty, Inc.,* 24 A.D.3d 519, 806 N.Y.S.2d 244 (2005), the grantor received an offer from a third party to purchase the subject property for $2,000,000, contingent upon the execution of a "mutually acceptable Contract of Sale, based on commercially reasonable terms." The holder of the ROFR confirmed in writing that it wanted to exercise it, subject to its receipt of a commercially reasonable contract of sale, but it acknowledged that, at the time it was advised that the grantor was no longer interested in selling, there were open items left to be negotiated and it had not executed the grantor's proposed contract of sale. The court held that, because of the general rule that a ROFR does not give the holder the power to compel an unwilling owner to sell, the holder's purported acceptance was unenforceable. In a similar line of reasoning, the court in *Cipriano v. Glen Cove Lodge No. 1458*, 1 N.Y.3d 53, 801 N.E.2d 388 (2003) discussed the exercisability of a ROFR when the contract with the third party was abandoned but the holder had been wrongfully denied the opportunity to exercise it: the right is extinguished when the seller is no longer willing to sell, unless a binding contract was created prior to abandonment or expiration (even when the holder was given no opportunity to do so, given the facts before the court).

Avoiding Unreasonable Restraints on Alienation

New York courts have shown concern about restrictions on the future transfer of property, and will analyze preemptive rights to ensure that they do not pose unreasonable restraints on alienation. Per *Peters v. Smolian*, 49 Misc. 3d 408, 12 N.Y.S.3d 824 (N.Y. Sup. Ct. 2015), aff'd, 154 A.D.3d 980, 63 N.Y.S.3d 436 (2017), courts inquire into the reasonableness of ROFRs "to ensure the productive use and development of property by simplifying ownership, facilitating exchange and freeing property from unknown or embarrassing impediments to alienability."

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New York courts have judged the reasonableness of a ROFR by weighing the period the right remains exercisable, the extent to which the purchase price is equal to fair market value or the third party's offer, and the purpose of the right.

The ROFR at issue in *Metro. Transp. Auth. v. Bruken Realty Corp.*, 67 N.Y.2d 156, 492 N.E.2d 379 (1986) provides one example of a right deemed sufficiently reasonable under the common-law rule against unreasonable restraints to be enforceable, as the court upheld a right for a market value purchase price and that was exercisable for 90 days after the grantor's decision to sell. While there are plentiful examples of ROFRs that have been deemed reasonable by the courts, there is an upper limit.

The ROFR at issue in *Herrmann v. AMD Realty, Inc.*, 1 Misc. 3d 586, 765 N.Y.S.2d 232 (N.Y. Sup. Ct. 2003), aff'd, 8 A.D.3d 619, 779 N.Y.S.2d 560 (2004) gave the grantor the right to accept a bona fide third party contract in its own name, but with a $75,000 cap on the purchase price that the holder would pay. In its declaratory judgment, the court found the ROFR was null and void because it violated the common-law rule in light of the appraised value of $270,000 and the $300,000 purchase price offered by another party. To allay any judicial concerns with restraints on alienation, the parties should ensure the right as drafted is not unreasonable in the terms of its exercisability.

Conclusion

While certain default mechanisms or considerations have been used by the courts when a ROFR is silent or unclear on a matter, New York courts have repeatedly held that the language agreed upon and drafted by the parties is of paramount importance and can be used to overcome a court's default rules. Clarity and specificity are key, as they not only help the parties avoid disputes but also help the courts resolve them.