

OPTIONS, RIGHTS OF FIRST REFUSAL,
RIGHTS OF FIRST NEGOTIATION AND RIGHTS OF FIRST OFFER
A GUIDE THROUGH THE MAZE

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In the real estate world, whether it be an office lease or a purchase and sale contract, the parties will often have to consider some form of future option affecting the parties' respective rights and obligations. In office and retail leasing, the tenant often needs future expansion rights, or may want the right to purchase the property. In residential leasing, the tenant may be given a right to purchase her unit if it is converted into a condominium or is resold. In purchase and sale agreements, the buyer may insist on the future right to buy adjacent parcels, or to at least have the opportunity to buy the parcels before the existing owner sells to a third party. In each case, these rights can become a hot button issue when negotiating real estate agreements.

If one party to a contract is looking for flexibility in dealing with its future requirements, the other party is being called upon to encumber its future rights to provide that flexibility. This article briefly outlines the various approaches used to balance these competing interests.

I. **Options.**

Example: Betty is hereby granted the option to purchase all, but not less than all of Sam's vacant land located at 341 Second Street, City of Los Angeles, legally described on Exhibit A hereto, for a price of \$200,000 in cash, exercisable at any time within 18 months after the date hereof, with the closing of such purchase to occur within 30 days after the exercise of the option. The parties shall share all closing costs, including title, escrow, and recording fees equally.

The clearest and strongest right that can be granted to give a party flexibility in the future is an option. Under an option, the person who is granted the option ("optionee") is given the right, but not the obligation, to lease, buy or otherwise control a specified asset in the future. To be enforceable, the option should spell out exactly what asset is subject to the option (e.g., a specific suite in a office building, a specific parcel of land, or a designated item of personal property). The option should specify the price and terms on which the optionee can exercise the option, the outside date for exercising the option, and the corresponding dates for the grantor of the option to deliver the optioned asset. Many options fail to be valid because the details are not spelled out and a court may refuse to fill in the missing details of the purported agreement between the parties. A classic example of this is an option that gives Betty the right to buy Sam's vacant lot, provided Betty gives Sam notice of her exercise of the option before January 1, 2000. If Betty gives that notice as required, and Sam decides he does not want to sell the lot to Betty any longer, he can probably avoid

the option, since it failed to state the price at which Betty could buy the lot. In addition, the option failed to state when the lot had to be delivered to Betty.

II. **Right of First Refusal.**

Example: Tenant is hereby granted a right of first refusal to lease Suite 550 in the Building for the same rent, for the same term, and on the same terms and conditions as Landlord is prepared to accept from a third party tenant at any time during the period from the date hereof until the fifth anniversary hereof. Landlord shall notify Tenant of the receipt of any offer to lease Suite 550 from any third party during said 5 year period that Landlord is prepared to accept, prior to accepting the same, and Tenant shall have 30 days after receipt thereof to notify Landlord that Tenant elects to exercise its right of first refusal and lease Suite 550 on such terms and conditions, in which case the lease will be amended to add Suite 550 to the Premises on such terms and conditions.

As an alternative to an option, parties to real estate agreements sometimes consider using a right of first refusal. Unlike an option, the right of first refusal does not give the holder of the right the ability to force the other party to sell or lease the asset: it generally will provide that the holder of the right has the ability to require that the asset be sold or leased to such holder on the same price and terms that the owner is willing to accept from a third party, if and when the other party decides to sell or lease the asset to any third party. Obviously, a right of first refusal is much weaker from the standpoint of the holder than an option, and allows the owner of the asset to control the timing of the transaction. Equally important, however, is the fact that a right of first refusal does not set the price for the asset in advance. Many grantors of options rue the day they granted an option, only to find the value of their assets has increased considerably since the original option was granted. In contrast, the grantor of a right of first refusal is generally not exposed to this kind of disadvantage, since the price will be determined by what the owner of the asset will accept in a current deal.

For example, in an office lease, a tenant may not be able to get the landlord to grant him an option on adjacent space, but may be able to get a right of first refusal from the landlord that allows that tenant to lease the adjacent space if and when the landlord is willing to accept a lease to a third party for that space, for the same rent and term as the third party.

Since a right of first refusal is triggered by a bona fide offer from a third party to the owner (or in some cases by an offer from the owner to a third party), the right of first refusal provision should specify what qualifies as an offer to trigger the right. In the leasing context, such an offer might be in the form of a fully negotiated letter of intent or even a fully negotiated lease. If an existing tenant has a right of first refusal and agrees to all of the terms of the third party offer, that tenant has the superior right to lease the space on those terms, and the landlord is bound to lease the space to that tenant on those terms. Conversely, if the existing tenant agrees to only some, but not all, of the terms offered by the third party, the landlord may decide not to lease the space to the existing tenant and close the deal with the third party.

Owners resist granting rights of first refusal because they have a chilling effect on the marketability of the owner's property. Brokers and interested parties are reluctant to expend substantial time and money to negotiate a lease or purchase agreement for a deal, knowing the owner has to submit the final deal to the holder of the right of first refusal, who can then elect to lease or purchase the property on the terms presented to him and thereby take advantage of a fully negotiated deal.

III. Rights of First Negotiation.

Example: If Sam intends to sell his Building, Sam shall first so notify Betty and Betty shall have the right, by notice to Sam within 10 days, to invoke her right of first negotiation hereunder. If Betty invokes such right, Sam and Betty shall enter into good faith exclusive negotiations for a period of up to 30 days thereafter for the sale of the Building to Betty on mutually acceptable terms and conditions. Sam shall not sell the Building to any third party during such negotiation period.

In order to avoid the chilling effect of a right of first refusal, the parties may instead use a right of first negotiation. Under a right of first negotiation, the holder of the right has the right to engage in good faith exclusive negotiations with the owner of the property, which can be triggered before that owner offers the property for sale or lease to another party. The obvious advantage of a right of first negotiation over a first refusal right, from the owner's perspective, is that as long as the right is triggered before the owner has to invest time and money in negotiating a deal with a third party, there is no chill on the marketability of the asset, once the right of first negotiation period has lapsed. Under such an approach, the owner must notify the holder of the right that the owner intends to sell or lease his property and the parties then have a specific period of time in which to negotiate, on an exclusive basis, a mutually acceptable deal.

A right of first negotiation does not give the holder of the right any assurance that the parties will reach final agreement on the price and terms for the transaction. If no agreement on price or terms is reached, then the owner of the property is generally free to sell or lease it to a third party free and clear of the rights of the holder of the first negotiation right.

Sophisticated parties to real estate agreements use a variety of techniques to give more substance to a right of first negotiation. In order to assure that the price demanded by the owner is a fair one, the owner can be prohibited from selling or leasing his property to a third party for a price that is less than (or in some cases less than a specified percentage of) the price last offered by the holder of the first negotiation right during the negotiation period. Additionally, the parties may agree that if the owner fails to sell or lease the asset to a third party within a specified time period, then the owner has to again give the holder of the right the ability to negotiate exclusively for the sale or lease of the asset for an additional period. This approach requires that the parties share information about any deals concerning the property, even if the initial parties fail to reach an agreement during the original negotiation period.

Another technique that is used to give more meat to the right of first negotiation is to require that the owner of the property negotiate in good faith with the other party to reach agreement on the price and terms: this brings into play a body of case law in California concerning the conduct of the parties during their negotiations. If the owner acts in bad faith and refuses to consider fairly and honestly the offers made by the holder of the right during the exclusive negotiation period, then the holder of the right may have a cause of action against the owner to force him to consider such offers, and to block the owner's ability to sell or lease to a third party until such offers are duly considered.

IV. Rights of First Offer.

Example: Betty is hereby granted the right to make the first offer for the purchase of the Building on the land legally described on Exhibit A if Sam elects to sell the Building at any time within the 2 year period commencing on the date hereof. Sam shall notify Betty of his intent to sell the Building at least 45 days prior to entering into any binding agreement to sell the Building to any third party, and Betty shall have the right, within 30 days thereafter to submit her offer for the purchase of the Building, including the price and terms of such purchase. Sam shall have 10 days after receipt of Betty's offer to accept or reject her offer, in Sam's sole discretion; provided, however, that if Sam rejects such offer, then Sam shall not be permitted to sell the Building to any third party for a price or terms that are less favorable to Sam than the terms of Betty's offer. If Sam fails to sell the Building to a third party for a price and on terms equal to or better than Betty's offer within 6 months after the date of her offer, then Betty shall have the right to make a new offer to purchase the Building and the foregoing right of first offer shall again apply.

In some transactions, particularly involving the sale of real estate, the parties provide for a right of first offer ("ROFO") in favor of the buyer. The holder of a ROFO has the first right to make an offer for the purchase of the property before the owner can sell the property to a third party. The owner is given a specific period to accept or reject the offer, and if the owner rejects the offer, he is free to sell the asset to one or more third parties, with the only restriction being that he cannot accept a price that is less (or in some cases less than a percentage of) the price offered by the holder of the ROFO. This puts the holder of the ROFO in the position of naming its price without knowing the owner's estimate of the value and without the opportunity to require the owner to negotiate to an agreed price (unless that right is included in the agreement). The ROFO is used, for example, where a purchaser of a parcel wants a right to buy the adjacent parcels when they become available for sale, but the owner is unwilling to give an option or right of first refusal.

Another approach that can be used to give more protection for the holder of a ROFO is to require the owner of the property to make the initial offer to the holder of the ROFO, naming the price and terms that the owner will accept, before that owner can sell to a third party. This approach, of course, has the advantage for the holder of the ROFO of revealing the price that the owner will accept (if the owner is obligated to sell at that price or higher if the ROFO holder does not accept the offer). The disadvantage is that the ROFO holder still cannot force the owner to engage in

meaningful negotiations if the price is too high (absent other provisions in the contract), and the ROFO holder remains subject to the timing of the owner as to a sale of the property.

In each of the foregoing cases, it is also important for the parties to address the priority of conflicting rights to the property. For example, in the case of office space, one tenant may have an expansion option, another tenant may have a right of first refusal if the first tenant does not exercise its option, and a third tenant may have a right of first negotiation, subject to the rights of the other two tenants.

The parties have to be careful to carve out from any of these rights any excluded transactions, such as a transfer of property between a parent corporation and its subsidiary, or between two affiliated entities.

These various mechanisms are just some of the ways that sophisticated parties in today's real estate transactions can provide creative means for protecting their rights and allowing flexibility.