PHILADELPHIA, MONDAY, JULY 19, 2004

The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES

ALM

REAL ESTATE

Rights of First Refusal: Defining the Triggering Event

BY MARTIN DOYLE
AND DAVID FELDER
Special to the Legal

While a right of first refusal is given form and content only within the context of a specific transaction, in general terms, a ROFR obligates an owner of property to offer to sell the property to the holder of the right before the property may be sold to a third party. The parties to a ROFR are typically the property owner (the grantor), whose property is burdened by the ROFR, and the recipient of the right in whose favor the ROFR is created (the holder).

Although ROFRs can stand alone, they are frequently granted in connection with another transaction. For example, the grantor and holder may be parties to a lease that includes a ROFR with respect to the property covered by the lease. A ROFR may give the holder the right to buy property, to lease the property, or to acquire some other interest.

However, the holder does not have the right to acquire the relevant interest at will. The holder's right to purchase or lease always depends upon the occurrence of a triggering event, which is generally under the control of the grantor. By contrast, in the case of an option, the option holder has a unilateral right to purchase or lease the property at some point in the future on stated terms.

The triggering event for most ROFRs is a decision by the grantor to sell the property. For example, the ROFR may provide that the holder has the right to purchase the property if either the grantor receives an offer from a third party which the grantor intends to accept, or the grantor intends to offer the property for sale to a third party. In either case, before entering into a binding agreement to sell the property to a third party, the grantor must first offer to sell the property to the holder.

Typically, the terms of the proposed sale to the third party dictate the terms of the offer to the holder. The grantor must offer to sell the property to the holder upon exactly the same terms as the grantor is prepared to sell to the third party. If the holder does not exercise the ROFR, the grantor is then free to sell the property to the third party upon the proposed terms.

The occurrence or non-occurrence of the triggering event is one of the most frequently litigated aspects of ROFRs. In the context of a specific set of facts, it is not always clear from the terms of the ROFR whether the parties intended that the particular event or transaction trigger the holder's right to purchase. This article considers some examples of situations where, unless the parties have specifically addressed the relevant scenario in the ROFR, they can easily find themselves in disagreement concerning whether the triggering event has occurred

BONA FIDE SALES

ROFRs work on the theory that the proposed sale to a third party is a bona fide, arms-length transaction for market value, which thus provides a fair basis for fixing the terms under which the holder is entitled to purchase the property. There are any number of circumstances, however, in which the proposed third-party transfer may not be arms-length. The third party, for example, may be a family member, a related corporation or a major shareholder of the selling corporation. The sale may be for a bargain consideration, with the intention of making a charitable gift as to the balance. The transfer may be by operation of law or pursuant to a judicial sale. In such cases, the mechanism for fixing the terms of the sale to the holder breaks down. The stated purchase price in such cases may be too high — since the payment may be going from one pocket to the other — or too low, if it includes an element of gift.

DOYLE

FELDER

MARTIN DOYLE *and* **DAVID FELDER** *are members of Saul Ewing's real estate department in the firm's Philadelphia office. Both have worked on a number of major real estate transactions and have been involved in all aspects of real estate development, sales, finance and leasing. Doyle received a law degree, cum laude, from the University of Pennsylvania Law School. Felder received his J.D. degree, cum laude, from Harvard Law School.*

Frequently, the legal documents creating the ROFR provide little guidance regarding the parties' intentions in the case of proposed transfers to third parties that are not bona fide, arms-length transactions. There is some case law in Pennsylvania regarding the rights and obligations of the grantor and holder in such circumstances.

In a 1989 case, *Mericle v. Wolf*, the Pennsylvania Superior Court held that a donation of real estate to a hospital did not trigger the ROFR since there was no "sale," within the meaning of the operative legal documents. The Superior Court distinguished a 1975 decision, *Warden v. Taylor*, in which the

Supreme Court held that a gift by grandparents to a grandson triggered the holder's right to purchase. The ROFR in *Warden* provided that if the grantor decided to "sell and convey" the property, the holder — a former owner — had the right to repurchase. According to the Superior Court in *Mericle*, *Warden* was distinguished by, among others things, the use of the word "convey," which expressed an intention to activate the ROFR upon any type of transfer, not just a sale.

The Pennsylvania Superior Court recently addressed the question of whether a sale to a related party triggers a holder's right to purchase.

In *Lehn's Court Management LLC v. My Mouna Inc.,* the grantor sold property to its sole shareholder, George Moussa, without offering to sell the property to the holder of the ROFR. The Superior Court held that the transfer to Moussa was not a triggering event under the lease because the transfer to the sole shareholder was not a "sale."

Citing cases from Colorado, Rhode Island, New Jersey and Utah, the Superior Court said that "for purposes of a right of first refusal, a 'sale' occurs upon the transfer (a) for value (b) of a significant interest in the subject property (c) to a stranger to the lease, (d) who thereby gains substantial control over the leased property." Although the first two requirements were met, the last two were not.

Based upon existing Pennsylvania case law, the grantor's interests may be sufficiently protected by simply defining the triggering event as a proposed sale of the property. This would appear to allow future flexibility with respect to charitable gifts, corporate restructurings and intra-family transfers without triggering the ROFR. Alternatively, in order to avoid the possibility of future disputes with the holder, the grantor may wish to expressly provide that transfers that are not bona fide, arms- length transfers for market value do not trigger the ROFR.

From the holder's perspective, either approach allows the grantor to make transfers that bypass the ROFR, with the result that the triggering event is delayed or may never occur. The holder may wish to preclude transfers that are not bona fide, arms-length transactions during the term of the ROFR or to provide that non-arms-length transactions do trigger the ROFR. In the latter case, however, the parties must establish a separate mechanism for determining price, since the terms of the proposed transfer to the third party may not reflect true market value. The parties may agree, for example, that in such cases, the purchase price will be determined by appraisal or by arbitration.

FEE SIMPLE INTERESTS

A similar question that has come before the courts is whether the transfer of something other than a fee simple interest is a "sale of property" under the particular ROFR. In *Kelaco v. Davis & McKean General Partnership*, the Pennsylvania Superior Court ruled that the grant of an access easement did not activate the holder's right to purchase, since the easement did not involve the sale of property. This case is easy enough, but there are others that are more difficult. For example, a grantor may enter into a long-term lease of the property with a third party instead of transferring the property by deed.

In *Kings Antiques Corp. v. Varsity Properties Inc.,* the New York Supreme Court, Appellate Division, held that the execution of an 84 year lease did not trigger a ROFR. The court said that "[a] net lease is not a conveyance amounting to a 'sale' of property so as to activate plaintiff's right of first refusal, absent a showing that the net lease was a 'sham' or otherwise entered into in bad faith for the purpose of defeating plaintiff's rights."

Another difficult issue is whether a ROFR is triggered where a partner or shareholder sells its interest in a single asset entity rather than causing the entity to sell the asset. In *Power Test Petroleum Distributors v. Baker-Tripi Realty Corp.*, the New York Supreme Court, Appellate Division, held that absent a showing of bad faith, the sale of the stock of a single purpose entity rather than its real estate did not trigger a ROFR which, by its terms, was activated upon the sale of the property.

The only Pennsylvania case on this issue is *Lammisa v. Deutsch*, a 1982 decision of the Court of Common Pleas of Allegheny County. In *Lammisa,* the court addressed the question of whether a ROFR was activated when one of four partners sold her partnership interest in the entity to her three other partners. The court said that it was not. "[I]n a sale of the interest of one partner to another, there is no transfer of title to the real estate. The real estate was owned by [the partnership] before the transfer of the [partner's] interest and was still owned by [the partnership] after the transfer." The decision of the Court of Common Pleas was affirmed by the Superior Court without a published opinion.

CONCLUSION

Based upon existing case law, when the parties to a ROFR define the triggering event as simply "a proposed sale of the property," it is likely that the interests of the holder in particular are not adequately protected. This is because the courts have narrowly construed the meaning of the term "sale" as the transfer of a fee interest to an unrelated third party, with the result that there are a number of "sale-like" transfers that do not trigger the ROFR.

Accordingly, if it is the intention of the parties that such transactions trigger the ROFR, the holder in particular must take care to negotiate ROFR language that is more comprehensive than the generic "proposed sale" formula. Both parties, however, will be well served by having a document that clearly defines those events that activate the ROFR and those that do not. •