

Commentary

Elective Procedures

Tenants And Buyers Benefit From An Understanding Of Basic Future Rights.

by Paul S. Rutter and Duane M. Montgomery

Whether contemplating an office lease or a purchase-and-sale contract, those real estate professionals responsible for clients' transactions will often have them consider some form of future option affecting their rights and obligations.

In office and retail leasing, the tenant often wants future expansion rights or the right to purchase the property. 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 them before the owner sells to a third party.

These rights can become a hot-button issue when negotiating real estate agreements. If one party is looking for future flexibility, the other party is being called on to encumber its right to provide that flexibility.

Options. The clearest and strongest right that can be granted to give a party future flexibility is an option. An optionee is given the right, but not the obligation, to lease, buy or otherwise control a specified property in the future. To be enforceable, the option should spell out exactly what property is subject to the option (e.g., a specific suite in an office building or a specific parcel of land). The option should specify the price and terms, the outside date for exercise and the dates the grantor must deliver the optioned property.

Many options are not 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.

Right of first refusal. Parties to real estate agreements sometimes consider using a right of first refusal as an alternative to an option. Unlike an option, the right of first refusal does not give the holder the ability to force the other party to sell or lease the property. It generally will provide that the holder has the ability to require the owner to sell or lease the property to the holder for the same price and terms the owner is willing to accept from a third party, if and when the owner decides to sell or lease.

For the holder, a right of first refusal is much weaker than an option, and allows the property owner to control the timing of the transaction. Equally important, a right of first refusal does not set the price in advance. Many grantors of options rue the day they granted an option, only to find the properties' value 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 disadvantage, since the price will be determined by what the owner will accept in a current deal.

Since a right of first refusal is triggered by a third party's bona fide offer to the owner (or by the owner's offer to a third party), the right-of-first-refusal provision should specify what qualifies as an offer. In the leasing context, 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 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, the terms the third party offered, 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 property. Brokers and interested parties are reluctant to expend substantial time and money to negotiate a lease or purchase agreement 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 take advantage of a fully negotiated deal.

Rights of first negotiation. To avoid the chilling effect of a right of first refusal, the parties may instead use a right of first negotiation. Under this provision, the holder has the right to engage in good-faith, exclusive negotiations with the property owner. The negotiations can be triggered before the owner offers the property for sale or lease to another party. The 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 with a third party, there is no chill on the property's marketability once the negotiation period has lapsed.

KOREK LAND COMPANY, INC.

15230 BURBANK BLVD., SUITE 101 • SHERMAN OAKS, CA 91411 • (818) 787-3077 • FAX (818) 787-9677
www.korekland.com • mail@korekland.com

Under this approach, the owner must notify the holder that the owner intends to sell or lease the property. The parties then have a specific time in which to negotiate a mutually acceptable, exclusive deal.

A right of first negotiation does not give the holder assurance that the parties will reach final agreement on price and terms. If no agreement is reached, then the property owner is generally free to sell or lease it to a third party unencumbered by 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. To assure that the price the owner demands is fair, the owner can be prohibited from selling or leasing the property to a third party for a price less than (or less than a specified percentage of) the price the holder last offered during the negotiation period.

Additionally, the parties may agree that if the owner fails to sell or lease the property to a third party within a specified time, the owner has to again give the holder the ability to negotiate exclusively for the sale or lease of the property for an additional period. This approach requires the parties to share information about deals concerning the property, even if the initial parties fail to reach an agreement during the original negotiation period.

Rights of first offer. In some real estate transactions the parties provide for a right of first offer in favor of the buyer. The holder has the first right to make an offer to purchase 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, is free to sell the property to one or more third parties. The only restriction is that the owner cannot accept a price less than (or less than a percentage of) the price the holder offered. This puts the holder in the position of naming its price without knowing the owner's value estimate and without the opportunity to require the owner to negotiate to an agreed price (unless that right is included in the agreement).

The right of first offer is used, for example, when a purchaser of a parcel wants a right to buy adjacent parcels when they become available for sale, but the owner is unwilling to give an option or right of first refusal.

Conflicting rights. It is always important for parties to address the priority of conflicting rights. For example, for 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.

Parties have to be careful to carve out from 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 sophisticated parties in today's real estate transactions can provide creative means for protecting their rights and allowing flexibility.

Written by Paul S. Rutter and Duane M. Montgomery of the Law Offices of Gilchrist & Rutter, Professional Corporation. Mr. Rutter and Mr. Montgomery can be reached at (310) 393-4000.

GUEST COMMENTARIES WELCOME, and may be printed at the sole discretion of **Korek Land Company**.

120299

Previous commentaries available upon request:

*A LENDER'S GUIDE TO MELLO-ROOS & ASSESSMENT LIENS, By Lewis G. Feldman, Esq. & Kathryn M. Lyddan, Esq.
THE BROKER AS YOUR AGENT AND THE BROKER'S FIDUCIARY RESPONSIBILITIES, By Arthur Mazirow
DEALING WITH THE WILLIAMSON ACT, By David L. Preiss
UNDERSTANDING THE REMEDY OF LIS PENDENS, By Fredric W. Kessler
LET THE FILER BEWARE THE RISKS OF A LIS PENDENS FILING, By Theresa M. Marchlewski, Esq.
DEVELOPMENT AGREEMENTS, By Robert Merritt & Geoffrey Robinson, McCutchen, Doyle, Brown & Enersen
HOMEOWNER ASSOCIATION CONSTRUCTION DEFECT LITIGATION AGAINST DEVELOPERS, By Richard H. Levin
FORECLOSURE BIDDING STRATEGIES & THE RISKS OF A FULL CREDIT BID, By John H. Kuhl & Douglas Snyder*