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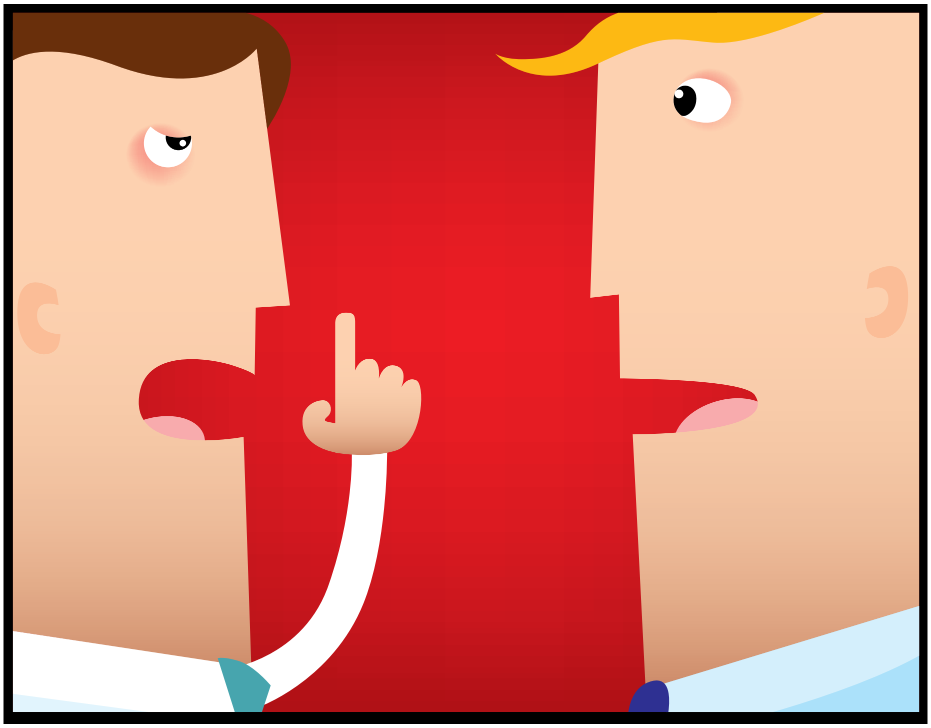
Dibs!

Understanding Right of First Refusal



By Judon Fambrough

"When you get ready to sell, give me a call." Ever heard that from a potential buyer? If the buyer is serious, he or she should be asking, "Will you grant me a right of first refusal for this property?"

A *right of first refusal* (ROFR) is a written agreement between a person wishing to purchase real property that is not currently for sale and the property owner who currently is not ready to sell it. The owner grants the prospective buyer an option to buy in the future after the owner-seller receives a bona fide (good faith) offer from a third party.

The ROFR does not grant the would-be buyer (holder) any immediate ownership rights. Instead, the owner simply agrees not to sell the property without giving the holder an opportunity to purchase the property based on the third party's offer.

Generally, the ROFR is between or among co-owners or cotenants. When one cotenant gets ready to sell his or her undivided interest, the other cotenant(s) have the right, based on the ROFR, to purchase the interest and avoid an unwanted cotenant.

An ROFR may be between adjacent landowners. Parties leasing land may want an ROFR from the owner.

Similar 'First Rights'

The ROFR should not be confused with other "first rights," such as the "right of first offer" or the "right of first negotiations." A right of first offer requires the owner to notify the holder before offering the land for sale to a third party. The holder has the right to make an offer that the owner may or may not accept. Because the holder does not know how the owner may value the property, a common practice requires the owner to specify the price and terms he or she is willing to accept. The price may be based on an appraisal or some other determinant.

A right of first negotiations, on the other hand, is less burdensome. This requires the owner to notify the holder of the owner's intent to sell the property. The parties have a specified period in which to negotiate exclusively for the purchase. If the parties cannot reach an agreement, the owner is free to sell the property to anyone.

Consideration for ROFR

For the most part, Texas law requires the exchange of consideration to make a contract (or option) irrevocable. But this is not necessarily true.

Texas courts have long held that consideration is required to create a binding, irrevocable agreement. However, in the *Joppich* opinion rendered by the Texas Supreme Court in 2004, the high court held that the mere mention of consideration in the agreement, even when not paid, is sufficient. To avoid problems, the agreement should spell out that consideration is required for the option, and the holder should pay it. The consideration should *never* be applied toward the purchase price.

Matching Bona Fide Offer

The owner's receipt of a bona fide, third-party offer generally triggers the ROFR. Thereafter, the holder must agree to match both the price and the terms of the agreement within a specified period. This raises the possibility of collusion between the seller and the third party.

Suppose a potential *cash buyer* approaches the owner to purchase the property. Before the buyer tenders an offer, the owner allows him or her to survey the property and conduct environmental assessments. The parties then contract for a cash closing in five days.

The holder, on the other hand, needs several weeks (possibly months) to arrange for a survey, acquire third-party financing and conduct environmental assessments. According to the agreement, the holder has 15 days to accept or reject the option and close within five days thereafter.

Has the owner received a bona fide offer in this situation? Must the holder match exactly the terms and conditions set forth in the third party's cash offer? Although there are some differences among the states, Texas case law generally requires the holder to match exactly the terms and conditions of the third party's offer unless the agreement states otherwise.

To avoid this and other problems, here are some considerations:

- A bona fide offer should not include a nonbinding, good-faith proposal or a letter of intent.
- A bona fide offer requires an enforceable sales contract, signed by both parties with the owner's receipt of nonrefundable consideration from the third party based on a percentage of the purchase price. (The consideration should be refunded if the holder accepts the offer.)
- The holder must match the price, but only the material or essential nonmonetary terms of the contract.
- Despite the terms of the third party's offer, the holder should be allowed reasonable time to seek third-party financing, conduct surveys and complete environmental assessments of the property before having to accept or reject the option. If this is not acceptable, see the next suggestion.
- Any special knowledge acquired or held by the third party seeking to purchase the property, such as surveys, environmental assessments and inspections, must be shared with the holder. The holder may be required to reimburse the third party for reasonable costs of acquiring the information if the holder relies on it to purchase the property.
- The owner may not, without reasonable justification, accept or insert special terms and conditions in the third party's offer known to be repugnant to the holder.
- The owner may not, without reasonable justification or without the holder's consent, place deed restrictions on the property after entering the ROFR that the owner knows contradicts the holder's anticipated use of the property.

Defining 'Triggering Event'

The ROFR agreement must address what event(s) trigger the option. For example:

- Do transfers by will or gifts to family members or to co-owners trigger the option? If not, does the ROFR continue to run with the land and bind the grantees?
- Do mortgage sales, tax foreclosures, bankruptcy and condemnation trigger the ROFR? Texas case law indicates that a mortgage foreclosure does not rise to the level of a bona fide purchase and trigger the ROFR when the ROFR was placed on the property prior to the mortgage. Otherwise, it does. This should be addressed in the agreement.

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Reinstating the ROFR

The agreement needs to address what events, if any, reinstate the ROFR. Suppose the holder rejects the option to purchase, but subsequent problems develop between the owner and the third-party buyer. The contract does not close or is amended significantly before closing. What effect does this have on the ROFR? These may be included in the agreement to avoid problems.

- If the third-party contract does not close, the ROFR must be reinstated against the property.
- If the owner and third party alter the price or amend significant terms and provisions of the contract after the option is rejected by the holder, the amended contract must be resubmitted to the holder. Otherwise, the holder has the following election. He or she may reinstate the ROFR against the property or immediately enforce it against the new buyer based on the terms of the amended contract.

- If the third-party buyer does not share special knowledge or information about the property with the holder when required, the ROFR may be reinstated against the property once the breach is discovered.

Duration of ROFR

Texas recognizes the Rule Against Perpetuities. This rule limits the length of time a restriction on conveyance, such as an ROFR, may be placed on (or enforced against) property. Generally, it cannot exceed 21 years after an identified living person or persons die. If no living person or persons are identified, the courts may find the interest void from its inception or that it lasts only 21 years after its creation.

To avoid the issue, the agreement should state the ROFR terminates upon the death of the owner (or owners) or 21 years after their death(s). The parties may agree to terminate it much sooner (five to ten years, for example). However, a termination date that does not violate the Rule Against Perpetuities should be stated.

ROFR Notifications

The agreement should specify how notice of the offer must be sent to the holder and how the holder must respond. Here is some suggested language:

> The owner must send the holder notice of receipt of a bona fide offer within ___ days after receiving it. The notice must be sent by certified mail, return receipt requested. The holder must respond within ___ days (the first day being the day after the notice is received) by certified mail, return receipt requested. If the holder does not respond within the specified time, the ROFR is deemed waived and a third party may rely on owner's recorded affidavit to that effect.

In lieu of the affidavit, some agreements require the holder to submit a recordable release of the ROFR to verify termination of agreement if the offer is rejected. The affidavit works better when the holder cannot be located.

Of course, the owner needs to be able to locate the holder when the option materializes. The agreement may require the notice be sent to the last known address. If the address is incorrect or if the holder refuses to accept the certified letter, the owner has fulfilled his or her obligation, and the ROFR terminates.

- The owner and holder must reduce the contract to writing on an approved TREC Form and sign it within ___ days after acceptance of the option.
- The holder must tender an escrow payment (of a certain amount) whenever the purchase contract is signed.

Finally, the agreement may allow the owner and holder to mutually modify the terms of the third-party contract.

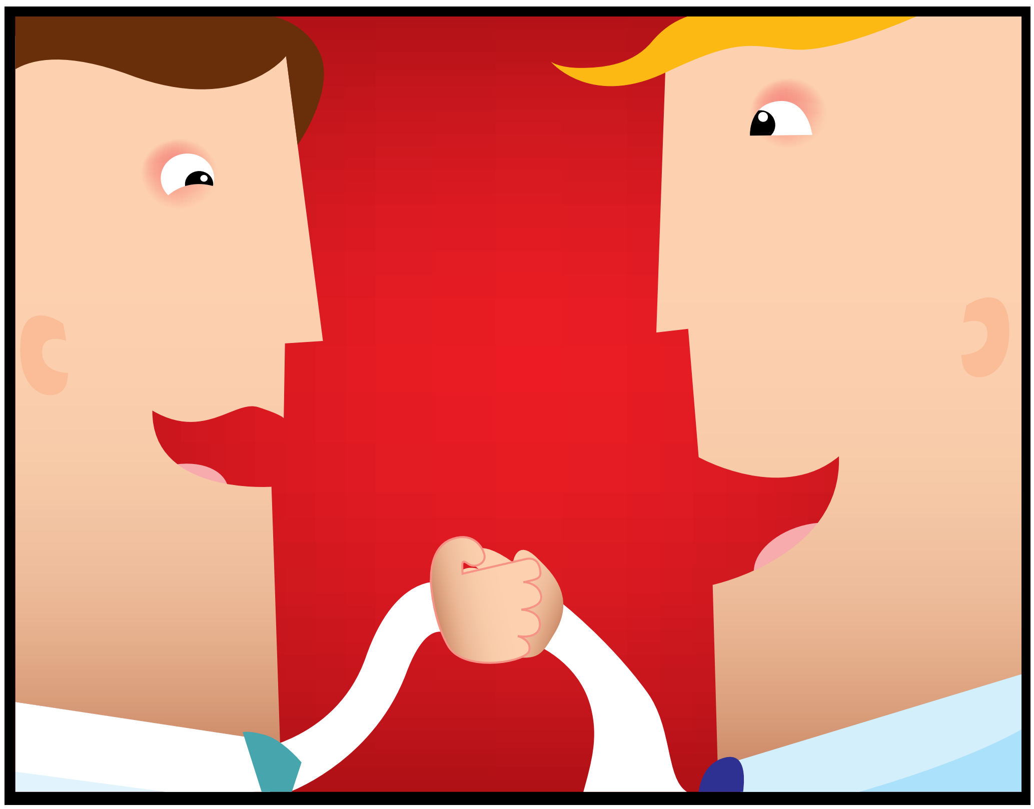
Deaths and Assignments

The effect of an owner's death was discussed earlier. However, what about the death of the holder? Does the ROFR pass to the holder's heirs, devisees or both? Likewise, can the holder assign the ROFR rights to a third party? Typically, the ROFR binds only the owner and holder. This issue should be addressed in the agreement.

Property Description, Partitioning

The agreement must contain a legal description of the property. The street address of residential property appears to be sufficient.

Rural land needs to be described more precisely. The agreement must detail whether the minerals, wind rights or other interests attached to the property (if owned by the seller) are



subject to the agreement. The effect of the owner's entering an oil and gas lease (which is a deed in Texas) needs to be discussed if the minerals are subject to the agreement.

If the ROFR is for rural land, the issue of subsequent partitioning and sale of the property needs to be resolved. Typically, the agreement states that the option continues and applies to any and all offers for all or any part of the described tract.

Recording the Agreement

The ROFR agreement binds the owner, the holder and those with actual or constructive knowledge of the agreement. The agreement is void (unenforceable) against a third party who pays valuable consideration for the property and has no actual or constructive knowledge of the ROFR. (This person is better known as a bona fide purchaser.)

Recording the agreement imparts constructive knowledge and prevents the possibility of a bona fide purchaser. For this reason, the ROFR should be recorded in each county where the property is located.

For the agreement to be recordable, it must be signed by the owner and acknowledged before a notary or two or more credible witnesses (Section 12.001, Texas Property Code). For more details on bona fide purchasers, see "Deeds and the Texas Recording Statutes" (publication 1267) at recenter.tamu.edu.

To avoid problems, both the owner and the holder should sign the agreement before a notary and record it. This ensures that the parties are in agreement regarding the details and no unauthorized changes occur.

Remedies for Breach

According to Texas case law, the owner's breach of the agreement (failure to submit the third party's offer to the holder) gives the holder an election to purchase based on the terms of the third party's offer or decline. This election must be made within the time specified in the agreement starting from the time the holder learns of the violation. According to case law, if no time is specified, it expires: (1) within a reasonable time, (2) by holder's express rejection or (3) by the holder demonstrating conduct inconsistent with an intent to purchase.

The holder has the right of specific performance against the party in possession if he or she decides to purchase. Basically, specific performance is a legal procedure whereby the courts enforce the terms of the ROFR against the owner. This could be against the owner, the third-party purchaser or some other party depending on the circumstances.

The owner and holder may wish to supplement these remedies. Perhaps the owner may be given the right to purchase a release of the ROFR from the holder for a stated amount — one price for purchasing the release before the sale and another after the sale based on a percentage of the purchase price. The agreement may impose liability on the owner for the holder's attorneys' fees if the owner breaches the agreement and the holder seeks specific performance in a court of law.

Licensees will encounter an ROFR sooner or later in the practice of real estate. When that happens, they need to be able to evaluate the agreement for themselves and for clients. Unforeseen and unanticipated problems not addressed in the agreement may cause misunderstandings and could result in litigation.

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THE TAKEAWAY

A right of first refusal is an agreement between a property owner and a second party who wants to have the first chance to purchase the property when it comes on the market. The agreement is triggered when the owner receives a third-party offer to buy the property.

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