



COOPERATIVES AND CONDOMINIUMS

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The Right of First Refusal: A Modest Proposal

COUNSEL FOR condominium boards of managers are increasingly receiving requests for advice as to the rights of a board if the seller of a unit withdraws or modifies the proposed transaction with a third-party purchaser either before or after the board has exercised its right of first refusal.

Is the seller nonetheless obligated to sell the unit to the board of managers on the original terms? Conversely, is the board of managers obligated to purchase the unit? And if no transaction closes, who is responsible for the costs and expenses incurred by the condominium (appraisal fees, legal and accounting fees, loan commitment fees and the like)?

This column addresses these issues and suggests how a condominium may try to create an enforceable right to purchase even if the third-party transaction is withdrawn and, in any event, can be protected from having to bear the costs of an aborted transaction.

An earlier column about the right of first refusal and its role in condominium bylaws¹ discussed the rationale behind the courts sustaining condominium bylaws provisions that give a board of managers a right of first refusal. That rationale teaches that if the third-party transaction is withdrawn, neither the seller nor the condominium board of managers is obligated to close, even if the right of first refusal has been exercised. Similarly, if the proposed transaction is modified before the right of first refusal is exercised, neither the seller nor the board are obligated to close on the original terms. However, if the transaction is modified after the right of first refusal is exercised, (for example, where the right is exercised on a \$700,000 purchase price and the price is subsequently modified to \$900,000), the board's ability to compel the seller to close on the original terms (\$700,000) is not free from doubt. Yet, if the "modification" raises issues as to the seller's good faith, that may, based on the precedents discussed in this column, obligate the seller to close with the board on the original



((\$700,000) price.

A New York Court of Appeals decision dealing with the exercise of a right of first refusal after the triggering transaction was withdrawn (albeit in the context of a sale of a business) supports this analysis.² That same decision, also offers a technique for creating an enforceable right to purchase, even if the triggering transaction has been withdrawn.

Rationale for Enforceability

The rationale of New York case law upholding the right of first refusal in the context of a proposed condominium unit sale to a third-party purchaser is stated in *Anderson v. East 72nd Street Condominium*.³ There, the court made clear that central to its holding is the preemptive nature of the right, which may be exercised "only when the [unit] owner freely decides to sell."⁴ In distinguishing this preemptive right from an option, the court relied on its unique character: a pre-emption does not give to the holder the power to compel an unwilling owner to sell. An option, by contrast, gives the optionee the power to compel the owner to sell at a stipulated price, whether or not he is willing to part with ownership.

This vitally important distinction between a preemptive right and an option — the absence or presence of an element of compulsion on the part of the holder — formed the basis for the court's determination that a right of first refusal by a condominium board of managers provided for in the bylaws was valid. The *Anderson* court reasoned that because the right of first refusal does not restrict the owner in the use of the property and the owner can never be forced to sell, the right of first refusal does not run afoul of the common-law rule against perpetuities.⁵ Rather, the right of first refusal is to be measured under the common-law prohibition against unreasonable restraints on

alienability. Measured by the test enunciated by the Court of Appeals in *Metropolitan Transportation Authority v. Bruken Realty Corp.*,⁶ the court found the condominium bylaws provision to be lawful. It was reasonable as to duration, price and purpose. Its "duration," measured by the period during which the right may be exercised, was reasonable — within 80 days of receiving notice from the owner of the proposed sale to a third-party purchaser. Its price was reasonable — the same price and terms as the proposed sale to a third-party. And its purpose was reasonable — to protect the economic interdependence of condominium unit owners in the financial affairs of the condominium entity.⁷

The *Anderson* court did not address the question of whether an exercised right of first refusal could be enforced after the third-party transaction was withdrawn. However, that issue was addressed, in part, in *Quigley v. Capalongo*.⁸

In *Quigley*, the owner sold land pursuant to an agreement that provided, with respect to a different parcel, that if the owner received a written offer for the purchase of the property during a five-year period, the owner would offer the property to the plaintiffs on the same terms and conditions. One year later, the owner received a written offer to purchase from Ithaca College, which was accepted. However, when the college learned of the agreement with plaintiffs, its offer and the acceptance were withdrawn by mutual consent and the parties entered into a long-term lease, to run until after the plaintiffs' right of first refusal expired, together with an exclusive option to purchase at the end of the lease term. Rental payments were to be credited against the purchase price.

Plaintiffs sued to specifically enforce their right of first refusal to purchase, arguing that the lease and option were a disguised sale and, therefore, a bad faith attempt to avoid the plaintiffs' right of first refusal. The court awarded plaintiffs specific performance, holding that the lease and option agreement "formalized defendant-owner's intention to sell the premises in response to the offer of Ithaca College, thus activating plaintiffs' right of first refusal."⁹

However, the court left open the issue with which we are concerned: "whether the acceptance of a bona fide purchase offer is enough by itself to activate a right of first refusal if the offer and acceptance are subsequently withdrawn in good faith."¹⁰ Our research has disclosed no New York

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case that addresses this question in the context of a real property transaction.

Withdrawal or Modification

Analysis of the rationale relied on by the *Anderson* court persuades us that a good-faith withdrawal of a third-party offer to purchase should not activate a right of first refusal. First, the purpose for which the right of first refusal was created is essentially a control technique to secure a community of qualified, congenial residents while protecting the value of their apartments.¹¹ This purpose was held by the *Anderson* court to be sufficient to satisfy the "purpose" portion of the tri-partite test for establishing the validity of a right of first refusal in condominium bylaws. However, where the sale to a third party is abandoned or withdrawn, that purpose is not present. The would-be seller remains a member of the condominium community and there is no further need to secure or protect the community. Thus, the exercise of a right of first refusal by a board when the primary motive is to capture a "bargain" purchase may always be vulnerable to a modification or withdrawal.

With regard to modification of a transaction before a right of first refusal is exercised, the *Anderson* rationale compels the conclusion that neither the seller nor the board can compel a closing on the original terms. However, with regard to a right of first refusal that is exercised before the modification is presented, there, the rationale of the *Quigley* court suggests that if the modification is presented in bad faith (for example, to try to extract a larger purchase price from the board), the "bad faith" modification will not vitiate the properly exercised right of first refusal and a closing may be compelled on the original terms. This analysis, therefore, behooves a board of managers to act as promptly as possible in determining whether to exercise a right of first refusal.

Moreover, in the context of a sale of a business, the Court of Appeals has made it clear that no right of first refusal may be exercised once the triggering transaction is withdrawn. In *LIN Broadcasting v. Metromedia*,¹² Metromedia entered into a contract with Southwest Bell whereby Bell was to buy from Metromedia its interest in two cellular phone businesses. Metromedia, however, had previously given LIN Broadcasting a right of first refusal with respect to these businesses and notified LIN Broadcasting of the Bell offer to purchase. Before LIN Broadcasting could exercise its right of first refusal, Metromedia notified it of its decision to keep the businesses. LIN Broadcasting responded by sending Bell a notice purporting to exercise its right of first refusal and commenced an action demanding, inter alia, specific performance of its right of first refusal. LIN Broadcasting argued that a first refusal offer, once made, is irrevocable for a period specified in the first refusal clause. The Appellate Division, First Department, dismissed the claim, reasoning that absent language "creating an irrevocable right [to compel a sale] there is nothing to prohibit a partner or shareholder from in good faith changing its mind about selling at any time prior to the invocation of the right of first refusal."¹³

In affirming, the Court of Appeals held that the purpose of a right of first refusal clause is to give to

the holder a power to control and restrict the other party's right to sell to a third party. The Court rejected LIN Broadcasting's contention — that the primary purpose of a right of first refusal is to enable the holder to eventually purchase the property. Instead, the Court held that once the selling party complies — by not selling without first making the required offer — "the intended effect of the clause as a means of restricting or preventing a sale to a third party has been realized [and] there is no basis for ... keeping the offer open for a period specified in the first refusal clause."¹⁴

Fixed-Term Option

The *LIN Broadcasting* court, in dicta, suggested a solution to the non-enforceability of a right of first refusal when the triggering transaction is withdrawn: "[T]here is nothing to prevent the contracting parties, if they chose, from simply agreeing on a provision that a first refusal offer, once made, must remain open for a specified time, making it an option."¹⁵ While this solution is certainly available in the context of a sale of a business, it may not be available when dealing with transactions in real property. There, the rule prohibiting unreasonable restraints upon alienability subjects the solution to the tripartite scrutiny enunciated in *Metropolitan Transportation Authority v. Broker Realty Corp.*¹⁶ Accordingly the "fixed term option" must be reasonable as to duration, price and purpose. Assuming arguendo that such an option were reasonable as to duration and price (for the same reasons found by the *Anderson* court), the "purpose" test may not be satisfied. For, if the board of managers may compel an unwilling seller to sell, where the economic interdependence of the condominium unit owners is plainly not at issue, where then is the proper purpose for the restraint? Thus, while the *LIN Broadcasting* decision may afford condominium boards a means by which to compel a sale to the board or its designee for the remaining period of the right of first refusal, its ultimate enforceability is not free from doubt.

Recovery of Expenses

When the owner of a unit offers to sell it to a condominium board of managers, a prudent board may immediately begin to incur costs. Because the period within which a right of first refusal may be exercised is typically very short (usually 30 days), a prudent board may seek legal advice and incur the costs of professionals (such as appraisers) in order to assist in determining whether the right of first refusal should, in the best interests of the condominium, be exercised. In addition, prudence may dictate that the board inquire of and independently research the bona fides and financial wherewithal of the proposed purchaser, in order to determine whether such purchaser may raise issues of concern for the condominium community. All of these inquiries and considerations could require the expenditure of not insubstantial amounts. However, if the proposed sale is withdrawn, the typical condominium bylaws do not provide for the seller

to reimburse the board for its actual costs, thereby requiring those costs to be borne by the condominium unit owners as a whole.

We therefore recommend that condominium bylaws provide (or be amended to provide) that when a seller gives notice to a board of a proposed transfer to a third-party purchaser and then modifies or withdraws the transaction the seller be obligated to pay the condominium's actual expenses-incurred, including actual legal expenses and other professional fees. Real Property Law §339-v(2)(a) permits the inclusion of "provisions governing the alienation, conveyance, sale ... ownership and occupancy of units"¹⁷ in condominium bylaws. A provision for recovery of expenses may, therefore, be included in a condominium's bylaws.¹⁸

Conclusion

While the law appears to disfavor allowing condominium boards to exercise a right of first refusal when the triggering transaction has been withdrawn, it may be possible for a condominium's bylaws to be crafted so as to create a fixed-term option that provides that a first-refusal offer, once made, must remain open for the time specified in the right of first refusal, notwithstanding the good-faith withdrawal of the triggering transaction. Nevertheless, in light of established real estate law policy and traditional rules, the enforceability of this option is not free from doubt. Moreover, without the option technique, even if a transaction is withdrawn or modified, a condominium's bylaws can be amended and crafted to provide that all of the actual costs and expenses incurred by the condominium board relating to the withdrawn transaction must be reimbursed by the would-be seller.

(1) See, Siegler, "The Right of First Refusal," *The New York Law Journal* at 3, col.1. (March 6, 2002).

(2) *LIN Broadcasting v. Metromedia*, 74 NY2d 54 (1989), 544 NYSupp2d 316.

(3) 119 AD2d 73, 505, NYS2d 101 (App. Div. 1st Dept. 1986).

(4) 119 AD2d at 77, 505 NYS2d at 103.

(5) See *Anderson*, 119 AD2d at 76 (stating that the Rule Against Perpetuities was created to prevent real property from being fettered with future interests so remote that the alienability of the land and its marketability would be impaired, preventing its full utilization for the benefit of society at large as well of its current owners).

(6) 67 NY2d 156 (1986).

(7) *Id.* at 168.

(8) 53 AD2d 714 (App. Div. 3rd Dept. 1976), 383 N.Y.S.2d 935, *aff'd.*, 43 N.Y.2d 748 (1977), 401 N.Y.S.2d 1009.

(9) 53 AD2d at 716.

(10) *Id.* at 715.

(11) See Siegler, "Troublesome Bylaws Provisions," *NYLJ* at 3, col. 1. (Sept. 18, 1991).

(12) *Supra*, fn. 2.

(13) *LIN Broadcasting v. Metromedia*, 139 AD2d 124, 133 (1st Dept. 1988), 531 N.Y.S.2d 514, 523.

(14) *Supra*, fn. 2, 74 NY2d at 54.

(15) *Supra*, fn. 2, 74 NY2d at 62.

(16) *Supra*, fn. 6.

(17) N.Y. Real Prop. Law §339-v(2)(a) (McKinney 1989).

(18) See Siegler, "Condominium Transfer Fees Revisited," *NYLJ* at 3, col. 1 (Nov. 7, 2001).

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