

**OPTIONS AND PREFERENTIAL RIGHTS: KEY ISSUES AND SAMPLE  
FORMS**

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## OPTION AND PREFERENTIAL RIGHTS: KEY ISSUES AND SAMPLE FORMS

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### I. INTRODUCTION.

Rights of first refusal, rights of first opportunity, expansion options, renewal options and similar provisions are often material parts of commercial and retail lease transactions. Unlike many lease provisions, these rights have significant operational issues for both the landlord and the tenant. This paper will define these rights, summarize the key issues with respect thereto and provide sample forms.

First, a word of caution. Although these rights and options have clear distinctions, the names are often used interchangeably, and lease provisions are often a combination of one or more rights and options. In other words, just because something is called a right of first refusal does not mean that is what it is. Each provision must be read and analyzed carefully, in the context of the specific lease document and with regard to what is intended, manageable and fair in connection with the transaction at hand.

### II. RIGHT OF FIRST REFUSAL

#### A. Definition.

A right of first refusal, in the context of leases, is the tenant's right to match the terms of a lease transaction the landlord desires to enter into with another party. Black's Law Dictionary defines a right of first refusal as follows (the definition speaks to a sale, but is equally applicable to a lease):

A potential buyer's contractual right to meet the terms of a third party's offer if the seller intends to accept that offer. For example, if Beth has a right of first refusal on the purchase of Sam's house, and if Sam intends to accept Terry's offer to buy the house for \$300,000, Beth can match the offer and prevent Terry from buying.

BLACK'S LAW DICTIONARY 1325 (7<sup>th</sup> ed. 1999).

Abbott's Encyclopedia of Real Estate Terms defines a right of first refusal as follows:

A right to be permitted the opportunity to acquire a particular property before it may be sold to another, but on similar terms. A right that can be exercised only when the owner has received a bona fide offer for the property from a third party. The term is colloquial and connotes that the owner of the property, prior to proceeding with the sale, will intimate the bona fide selling price and other relevant terms, to the person holding the right of first refusal. If the holder of the right agrees to that price and the other terms, the property is sold to him on that basis. A right of first refusal arises frequently as a right granted to a tenant to acquire his leased premise if the landlord

decides to sell its reversionary interest, or as a right of one co-owner to acquire another co-owner's interest in the same property.

ABBOTT'S ENCYCLOPEDIA OF REAL ESTATE TERMS 1018 (2<sup>nd</sup> ed. 2003).

Note that in order for the tenant to exercise its right of refusal, a triggering event- usually an offer from a third party that the landlord wants to accept- is required. A right of first refusal is a right to react to a transaction, and not a right to initiate a transaction.

## B. Key Landlord Issues.

Important right of first refusal issues from the landlord's perspective include the following:

1. Effect on Marketability. Probably the most important issue from the landlord's perspective is the adverse effect a right of first refusal may have on the marketability of the space. A prospective third party tenant who is aware that an existing tenant has the right to match any negotiated offer might be less inclined to spend time and money negotiating a deal. Additionally, a the prospective tenant may attempt to negotiate a reduction in the rental rate to compensate such party for the risk involved in negotiating a deal that is subject to a right of first refusal. The landlord can mitigate against these problems, at least to an extent, in two ways. First, the landlord can attempt to negotiate the right of first refusal provision in a manner that requires only the delivery of a summary of terms, as opposed to a fully negotiated document. This would avoid the need to impose on the prospective tenant the risk of potentially losing a fully negotiated deal. To make this more acceptable to the existing tenant, the right of first refusal provision could state that any material change in the terms presented to the existing tenant would require the landlord to resubmit the terms to the existing tenant for a second look. Second, the landlord can negotiate a very short response period once notice of the offer is given and a longer period after the rejection of such offer to consummate the transaction with the third party tenant. For example, a right of first refusal provision that grants the existing tenant 5 days to respond to a proposed offer and, if the tenant rejects the offer, gives the landlord a year to enter into a lease with the third party tenant before the right of first refusal begin becomes applicable would be less onerous than one that gives the existing tenant 30 days to respond to an offer and thereafter gives the landlord only 90 days to enter into a lease with the third party tenant.

2. Avoidance of Conflicting Rights. The importance of keeping an up-to-date, accurate list of preferential rights affecting space in the applicable project cannot be overstated. In order to accurately and efficiently manage the process of granting, documenting and complying with preferential rights, the landlord must always know which tenants hold preferential rights over which space, as well as the priority of such rights. Many disputes have arisen between landlords and tenants with respect to the landlord's alleged failure to comply with its obligations with respect to preferential rights. In order to minimize the effect on marketability of space, the landlord must be in the position to sequentially notice tenants holding preferential rights on space, in order to address and resolve preferential rights issues as quickly as possible. For example, the landlord's failure to give notice to an existing tenant holding a preferential right, or its failure to give prior notice to an existing tenant holding a senior preferential right, can require the landlord to re-notice all affected tenants. These inefficiencies can wreak havoc on the landlord's leasing efforts, and can expose the landlord to legal claims and damages.

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