LANDLORD-TENANT

Ruling Offers Useful Primer On the Right of First Refusal

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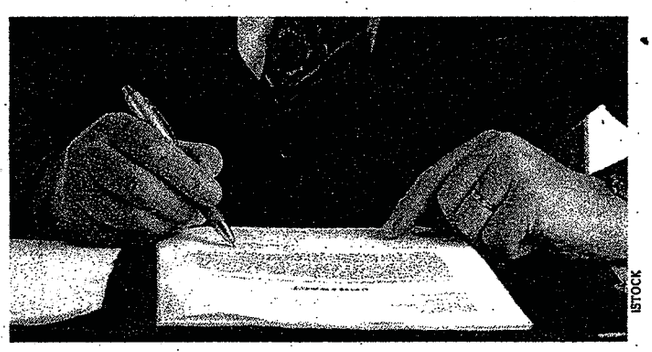
A recent decision by Supreme Court, Kings County Justice Carolyn E. Demarest in *Lester's Activewear, Inc. v. Combine Distributing Inc.*[1] is a useful primer on issues that can arise in connection with a tenant's exercising a right of first refusal. In that case, the lease gave the tenant a right of first refusal with respect to any sale by the landlord of the building where the tenant's store was located. Specifically, the lease granted the tenant the "privilege of purchasing the demised premises for the same price and upon the same terms as offered by a third party for a period of thirty (30) days after the Notice is sent, time being of the essence against the Tenant."

By letter dated Dec. 16, 2009, the landlord notified the tenant that it had entered into a contract for the sale of the building to an unidentified third-party. The landlord provided the tenant with a redacted copy of the contract of sale. In addition to a sale price of $1,625,000, the contract of sale also provided that, within six months after the closing, the purchaser would lend the seller up to $400,000 in connection with the closing of the seller's anticipated purchase of a replacement property for the property being sold, as part of a "like-kind" exchange pursuant to Section 1031 of the Internal Revenue Code. (As explained by the court in *Lester's Activewear, Inc.*, that tax provision "defers ... tax consequences on capital gains when the proceeds of a sale are invested in like property within six months (180 days) of the sale of the exchanged property.") The loan was to be secured by a first mortgage on the replacement property.

On Jan. 14, 2010, within the 30 days for exercising the right of first refusal, the tenant notified the landlord that it was electing to purchase the premises upon the terms set forth. However, the tenant further stated that the provisions for the purchaser to give the seller a loan were "unrelated to the Premises and otherwise improper, invalid, unenforceable and defective, and, therefore, are rejected."

The tenant demanded a contract of sale in compliance with its position, and stated that it would apply to court for relief if the landlord failed to confirm acceptance of the tenant's demand. The tenant's letter continued that:

> "In the event it is determined by a Court that the provisions of paragraph 40 of the Contract of Sale included with your notice [the provisions relating to the purchaser giving a loan to the seller] are valid and must be met by the Tenant as a condition of exercising its right of first refusal, then the Tenant hereby accepts such terms as well."[2]



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The landlord apparently did not respond to the tenant's notice of election to exercise the right of first refusal and the tenant commenced a lawsuit. The complaint contained three causes of action: one for declaratory judgment that the tenant had exercised its right of first refusal without accepting the loan provisions; a second seeking specific performance; and a third for injunctive relief. The tenant also moved, by order to show cause dated Jan. 19, 2010, for a preliminary injunction, with a temporary restraining order, to enjoin the landlord from selling the building to a third-party.

Initially, the court addressed the issue of whether the tenant's application was timely. The landlord argued that the tenant's application for injunctive relief should be denied because (1) the tenant did not obtain an extension of its right of first refusal in order to bring the lawsuit, and (2) the tenant's failure to execute the proffered contract and submit a down payment by Jan. 16, 2010 (i.e., within 30 days after notice from the landlord, time being of the essence) purportedly divested the court of the power to grant the injunction. The landlord analogized the situation to an application by a tenant for *Yellowstone* relief, where the application for such injunctive relief must be made before expiration of the cure period.

The court rejected the landlord's argument, concluding that "there is no reasonable analogy to the *Yellowstone* context." It noted that the tenant's application did "not affect [the tenant's] tenancy, which, all agree, would continue to 2012 under the terms of [its] lease even if the building were sold to third parties." Furthermore, the court commented, the tenant's application to stay any sale to a third party was brought prior to the Jan. 25, 2010 closing date of the third-party transaction and "promptly following [the tenant's] notice of election to purchase."

The court stated that there was "no disagreement that [the tenant's] lease contains an enforceable right of first refusal to purchase the premises on the same terms as those offered and accepted from a third party." Accordingly, the tenant "is entitled to specific performance where a valid election has been made." The court concluded that "[n]otwithstanding the present dispute regarding the terms, there was a valid, timely election by [the tenant] to purchase."

The court then addressed the issue of the loan provision to which the tenant objected. It rejected the tenant's argument that the provision was an arbitrary condition unrelated to the purchase of the subject premises. Rather, the court found that provision to be "entirely rational and to constitute an element of the consideration for the sale of the property for which [the tenant] holds the right of first refusal."

The court explained that "in order to avoid a substantial tax liability for the increase in value of the subject property over the 38 years" of owning it, the landlord decided to take advantage of Section 1031 of the Internal Revenue Code. That required investing the sale proceeds in like property, and the landlord desired to purchase a more expensive property in Michigan as the replacement property. Accordingly, the court stated, "[i]n order to assure the availability of financing" for that replacement property, the landlord, "*as a term of purchase for the subject premises,*" required that the purchaser provide the loan (emphasis added).

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The court also noted that the interest rate in the loan provision was "generous in today's market" and that both the 10-year term of the loan and the loan to value relationship were "not unreasonable." These facts supported the court's conclusion that there was nothing about the loan provision in any way suggesting that it was intended to discourage the tenant's exercise of its right of first refusal. Based on all of the above-discussed factors, the court found that the loan provision was "a binding element of the compensation provided in the Contract of Sale that must be met by [the tenant]."

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The court held that the tenant was entitled to specific performance on the purchase of the premises under the terms set forth in the contract of sale, including the loan provision, and also found that injunctive relief was warranted. The court directed that the tenant "shall forthwith execute the proffered Contract of Sale and provide a ten percent down payment." Noting that the contract of sale had provided for a closing date of Jan. 25, 2010, i.e., 40 days following execution of the contract, the court directed that the tenant must similarly close within 40 days of the date when the decision was originally rendered from the bench following oral argument.

The court in *Lester's Activewear Inc.* found inapposite three Appellate Division cases that the tenant had cited in support of its argument against having to meet the loan provision in exercising the right of first refusal. Those cases were *397 West 12th Street Corp. v. Zupa*,[3] *South Amherst, Ltd. v. H.B. Singer, LLC*[4] and *H.G. Fabric Discount, Inc. v. Pomerantz*.[5]

In *397 West 12th Street Corp.*, the tenant held a right of first refusal to purchase the property on West 12th Street in Manhattan where its premises were located. The landlord entered into a contract to sell that property to a third party for $14,000,000 and a separate contract to sell another property he owned on 10th Avenue to that same third party for $8,000,000. The parties agreed that both contracts were to close simultaneously or neither would close.

The tenant in *397 West 12th Street Corp.* alleged that, to circumvent its right of first refusal, the price of the West 12th Street property was increased above its market value and that of the 10th Avenue property was reduced below its market value. In any event, the tenant agreed to match the terms of the offer for the West 12th Street property, but then commenced the lawsuit to compel a sale to it of the 10th Avenue property also, or to have the price of the West 12th Street property reduced to what it contended more accurately reflected market value.

The Appellate Division, First Department stated as follows:

> "While defendant Zupa may not defeat plaintiff's right to exercise its right of first refusal to purchase the West 12th Street property by tying it to the sale of the 10th Avenue property, plaintiff [the tenant], having a right of first refusal to purchase only the West 12th Street property, may not obtain specific performance as to both properties."[6]

Accordingly, the court, modifying the trial court's decision, dismissed the tenant's claims insofar as they related to the 10th Avenue property.

In *South Amherst, Ltd.*, a tenant brought a lawsuit against its landlord for breach of contract to purchase leased premises under a right of first refusal. The landlord offered to sell the property to which the right of first refusal applied only as part of a larger parcel. The Appellate Division, Second Department, ruled that "a landlord may not attempt to defeat a tenant's right to purchase leased premises under a right of first refusal by offering it for sale only as part of a larger parcel." The court further stated that "absent an offer to sell just the leased portion of the premises [(i.e., the property subject to the right of first refusal)], the plaintiff, [defendant-landlord's] tenant, was under no obligation to exercise this right of first refusal and accordingly cannot be said to have waived that right."

In explaining why these cases are inapposite, the court in *Lester's Activewear, Inc.* stated that in these cases "the purchase of a second property, in addition to the property to which the right of first refusal related, was at issue." Presumably, the import of that distinction is that the second property was a separate and distinct property, such that the exercise of the right of first refusal could not reach to acquiring, nor be conditioned on acquiring, that second and distinct property. By contrast, in *Lester's Activewear, Inc.*, the loan provision, as analyzed by the court, was part of the consideration for the sale of the property to which the right of first refusal related. Thus, exercise of the right of first refusal appropriately could be conditioned on the tenant meeting that loan provision in the contract of sale.

In *H.G. Fabric Discount, Inc.*, a third party made an offer to purchase for $200,000 premises that were subject to a right of first refusal on condition that the premises were delivered vacant. The landlord informed the tenant of the offer. The tenant declined to purchase the premises and turned down the landlord's request to cancel the lease so that the premises could be sold vacant. Subsequently, the landlord transferred ownership to his son for $90,000.

The tenant sued, claiming that the sale of the property to the son violated its right of first refusal under the lease. It sought, inter alia, specific performance of that right so as to be able to purchase the premises for $90,000. The Appellate Division, Second Department, granted the tenant summary judgment on that cause of action, setting aside the conveyance to the son and directing specific performance on the tenant's right of first refusal at a price of $90,000.

The court held that the tenant had not waived its right of first refusal by declining to match the initial offer. The court stated:

> "It is well settled that lessees are not obligated to exercise an option of first refusal or suffer its forfeiture until the lessor has received a bona fide offer from a third party at terms which the lessor is willing to accept ... The lessor, however, must also be capable of accepting any such offer, that is, the conditions thereof must not be impossible to fulfill."[7]

In *H.G. Fabric Discount, Inc.*, the initial $200,000 offer to purchase was conditioned upon the premises being unoccupied. Since the premises were occupied by the tenant, who refused to vacate, and was under no duty to vacate, that condition was impossible to fulfill, according to the appellate court. Therefore, that court concluded, the tenant was never required to exercise its right of first refusal, and could not have waived it by declining to purchase the premises for $200,000. It still had an enforceable right of first refusal as to the $90,000 transfer by the landlord to his son.

A few questions readily come to mind in reading *Lester's Activewear, Inc.* For example, would the court's determination that the tenant had validly elected to purchase notwithstanding the dispute regarding the loan term have been different if, in giving notice of exercising the right of first refusal, the tenant had simply rejected the loan provision as purportedly invalid and not further stated that if a court held otherwise it was accepting that term as well? Would the court's determination that the loan provision was rational and constituted an element of consideration for the sale of the property have been different if the loan was not tied into a "like-kind exchange" pursuant to section 1031 of the Internal Revenue Code? What if the loan provision had instead required the purchaser to provide the seller with a loan any time within five years after closing if the seller requested such a loan?

In short, the decision in *Lester Activewear, Inc.*, and the cases it discusses, show that a right of first refusal and how it is exercised frequently is not a straightforward matter. It can become a chess match with landlord and tenant respectively developing strategies to defeat and preserve that right.

1. 27 Misc.3d 1204(A), 2010 N.Y.Slip Op. 50539 (u), NYLJ, April 14, 2010, p. 27, col. 3 (Sup.Ct. Kings Co.)
2. NYLJ, April 14, 2010 at p. 28 col. 1.
3. 34 A.D.3d 236, 824 N.Y.S.2d 35 (1st Dept. 2006).
4. 13 A.D.3d 515, 786 N.Y.S.2d 573 (2d Dept. 2004).
5. 130 A.D.2d 712, 515 N.Y.S.2d 823 (2d Dept. 1987).
6. 20 A.D.3d at 336, 799 N.Y.S.2d at 194.
7. 130 A.D.2d at 713, 515 N.Y.S.2d at 824-825.