LandThink, #48
September 4, 2009

What is a right of first refusal, and how does it work?

By Curtis Seltzer
Landthink contributor

A right of first refusal (RFR) in a real-estate contract is typically a mechanism that gives to a specific party the right to be the first allowed to purchase a particular property if it's offered for sale. The holder has the right to refuse to buy the property; it can be a confusing concept.

An RFR is a future right, and it is contingent on the property being put on the market. The terms of an RFR can range from vague and non-binding to very specific and very binding. An RFR can easily mean different things to different parties, so it's essential that both know precisely what each means by an RFR when it's first being discussed.

One type of RFR is essentially an option to buy the property before it's sold to any other buyer. The seller and holder/buyer may or may not agree at the time the RFR is negotiated to bind themselves to a specific price and other terms. The option may or may not end at some specific date in the future. The seller is not obligated to sell if price and terms have not been established when the RFR was set up.

A variation on the RFR as option price is an agreement to sell and buy at a price based on one or more appraisals when the RFR is invoked or as a percentage of the current value as agreed to by the parties when they negotiate the RFR. The parties could agree, for example, that 100 acres is worth $100,000 right now and the option price will be three percent higher during the term of each succeeding year, either compounded or not compounded.

A second type of RFR is the right of its holder to match any offer the seller has, thus preempting its sale to another party. The holder is usually not required to match an offer, but may choose at his option to do so.

A related idea is something called a Right of First Offer (ROFO), or Right of First Negotiation). The language usually requires the property owner to engage in good-faith bargaining with the ROFO holder before negotiating a sale with other parties. But an ROFO may simply give its holder the right to make an offer and not obligate the seller beyond looking at the holder's proposal. An ROFO could, but usually does not, bind the parties to come to an agreement. An ROFO gets the buyer's foot in the seller's door, but nothing is predictable after that.

Every RFR should be drafted as either an agreement or a contract (in which the holder gives some "consideration," or pays for, the right). It may bind the current owner alone or run with the land. In either case, I would advise having it recorded.

Both parties -- the holder of the right and the owner/seller -- find a self-interest in working out an RFR. The owner/seller's motivation may be cash in hand at the time the RFR is agreed to. The holder is usually motivated by a favorable price or terms down the road coupled with an improved ability to pay for the sale.

A purchased RFR typically sets forth a future (option) price and other terms. This gives both parties in current conditions certainty about a future time, price and other arrangements. If the holder cannot meet the RFR's terms in the future, the RFR is not exercised and the seller is free to sell or not sell to anyone. In most cases, the RFR holder has no claim for the money he paid in advance for the right he does not use.

An RFR can also be set up among ownership principals that allows those who wish to continue to own a jointly held property the right to make a first offer or match an offer to a partner who wants to exit the partnership or to that partner's estate. The holder/buyers get the chance to keep ownership among themselves, while the seller may be able to get the best price from those already in the deal. A fractional share in an ownership entirety is often discounted in the market, and a sale outside the group may penalize the seller.

RFRs of whatever type are usually set to expire at some specific future date. (This does not apply to ROFOs.) The longer the term of the RFR, the more uncertainty and risk each party accepts in light of market changes for the property's value. As a rule, time benefits the holder to the extent that real estate is appreciating on a fixed-price RFR. One or two years is the typical range. Some RFRs allow either seller or buyer to invoke the RFR at any point during its term. Others give the buyer the right to make an offer only at the end of the specified term.

A lender or mortgage broker may ask a borrower to agree to a refinancing RFR that obliges the borrower to work through the holder (i.e., lender or broker), or gives the holder the right to match any refinancing terms. Do not agree to this type of RFR, which, depending on its language, can gum up a sale or refinancing at better terms. If you have signed such an RFR with a lender, request a release and talk to a lawyer.

An RFR is not a do-it-yourself legal project. Both parties should get lawyers involved in drafting language and making sure that everyone understands how it will work.