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Rights of first refusal: The thorny issues raised by *Bramble*

To exercise properly a right of first refusal, must its holder ("pre-emptioner") accept every term of the third party's offer, even if it contains terms that the property owner knows will be repugnant to the pre-emptioner and will discourage the pre-emptioner from exercising the right of first refusal? According to a recent decision by Maryland's highest court, the answer is "no." *David A. Bramble, Inc. v. Thomas*, No. 32, Sept. Term. 2006, Jan. 8, 2007 (Md. Ct. App.).

Bramble raises some thorny drafting issues for real estate practitioners and may require these practitioners to exercise clairvoyant powers in assessing what may be "repugnant" to the pre-emptioner.

Facts

John and Rose Lane ("Lanes") owned a 26 acre parcel of unimproved land ("Property") in Caroline County that bordered property owned by David A. Bramble, Inc. ("Bramble"). On January 3, 2004, Merrill and Nancy Thomas ("Thomases") entered into a contract to buy the Property for $105,000.

This contract contained a hand written addendum stating that the contract was contingent on Bramble releasing the right of first refusal it held on the Property and an agreement by the Thomases not to use the Property for mining. Bramble's recorded right of first refusal, granted to it in 1992, provided that the Lanes would have to offer the Property to Bramble "for the price and on the terms of the intended sale" and that Bramble would then have 30 days within which to accept or reject the offer.

Less than two weeks after being notified of the Thomas/Lane contract, Bramble sought to exercise its right of first refusal by executing and delivering an agreement of sale to the Lanes. Bramble's offer matched the terms of the Thomas/Lane contract, but it did not contain the "no mining" prohibition. In early February 2004, the Lanes and Thomases amended their contract to increase the purchase price to $120,000 and to change the closing date. Bramble declined the request by the Lanes to match the revised terms.

The Lanes then asserted that Bramble's offer was actually a counteroffer and constituted an ineffective exercise of its right of first refusal because the offer failed to match all of the terms, including the mining prohibition.

In light of this brewing controversy, Bramble revised its offer to include the mining prohibition but kept the sales price at $105,000. Bramble tendered this offer 44 days after it was first notified of the Lanes' initial acceptance of the offer by the Thomases. The Lanes then decided not to sell the property to either the Thomases or Bramble.

The Thomases then brought a multi-count declaratory judgment action against the Lanes and Bramble in the Circuit Court for Caroline County. The Lanes and the Thomases filed motions for summary judgment.

In February 2005, the trial court ruled that the right of first refusal did not violate the rule against perpetuities but that Bramble's purported exercise of the right of first refusal was ineffectual because its first offer failed to contain the material term dealing with the mining prohibition.

The court thus granted Lanes' motion for summary judgment on this issue, whereupon Bramble filed an appeal to the Court of Special Appeals. In an unreported decision, the intermediate appellate court affirmed the trial court's judgment.

The Court of Appeals granted Bramble's petition for writ of certiorari.

Materiality of omitted provisions

The *Bramble* court discussed at length, but ultimately did not decide based on the posture of the case, whether a holder of a right of first refusal must match literally all the terms in the triggering offer to exercise its rights. The court remarked that "[t]here is some social and legal utility in applying" the mirror image rule on an exercise of a right of first refusal because that requirement tends to avoid the pre-emptioner from impeding the alienability of real property by claiming that the omitted non-price term is immaterial.

The court nonetheless observed that Maryland "generally" requires the literal matching of terms involving the formation of binding contracts, but the cases focusing specifically on rights of first refusal are "ambiguous at best in this regard."

Good faith and poison pills

The *Bramble* court held that a genuine issue of material fact existed as to whether the Lanes and the Thomases, or either of them, exercised bad faith in inserting the mining prohibition into the original offer as a "poison pill" to dissuade or frustrate Bramble from exercising its pre-emptive right.

Even in those jurisdictions where a

pre-emptioner in required to match exactly the terms of the triggering offer, there is an exception to the effect that a "property owner, for the purpose of discouraging the holder of the pre-emptive right from exercising its right of first refusal, may not insert into the triggering offer terms which it knows will be repugnant to the holder" and that are added in bad faith with the purpose of nullifying the right of first refusal.

The *Bramble* court pointed to the duty of the property owner and third party purchaser to act in good faith. As a result, the court imposed a duty of good faith and fair dealing on the property owner and the third party purchaser as striking the "proper balance."

Based on the record, the court concluded that summary judgment was inappropriate to resolve the rights of the parties because there was evidence, if believed, that the Lanes or the Thomases, or both, inserted the mining prohibition as a "poison pill" to discourage Bramble from exercising its right of first refusal. Bramble was mining land adjacent to the Property and intended to use the Property for mining. The mining prohibition would defeat Bramble's desire to buy the Property and thereby frustrate its bargained-for equitable interest in the Property.

Drafting considerations

Although the *Bramble* court did not rule on whether a pre-emptioner must match literally all the terms in the triggering offer to exercise its rights, the court's discussion makes clear that Maryland practitioners should carefully craft rights of first refusal to avoid the uncertainty raised in *Bramble*. Set forth below are several drafting considerations:

• The right of first refusal should specify that the pre-emptioner must match the precise terms and conditions of the triggering offer (i.e., the "mirror image rule") with no deviations or amendments.

• If it is not possible to include the mirror image rule in the right of first refusal, the next best alternative is to state that the pre-emptioner must match all "material" non-price terms and conditions set forth in the triggering offer.

It may be prudent to spell out many of the material non-price terms, such as the closing date, scope of representations and warranties, the survival period, liability caps, assignability of the contract, buyer's ability to perform pre-closing due diligence, whether the sale is on an "as is, with all faults" basis, and allocation for payment of applicable recordation and transfer taxes.

• The least desirable drafting approach is to simply state that the pre-emptioner must match "the" terms and conditions set forth in the triggering offer. This approach does not make clear whether the mirror image rule applies or whether the pre-emptioner must match the material non-price terms contained in the triggering offer.

Determining bad faith

The *Bramble* court discussed that a property owner or third-party purchaser may take steps to modify a non-price term in the triggering offer so as to dissuade the pre-emptioner from exercising its right of first refusal. If so, these parties would then have the burden of demonstrating that they did not act in bad faith but rather had "reasonable justification" for modifying a non-price term in the triggering offer to the disadvantage of the pre-emptioner.

The *Bramble* rule seems reasonable on its face. Parties should not be allowed, by acting in bad faith, to defeat a right of first refusal. Despite the salutary nature of this rule, the *Bramble* rule may be thorny in its practice.

A property owner must now focus on how its actions will be viewed, in hindsight, by a court and the pre-emptioner in fashioning the terms of the sale of the property subject to the right of first refusal. The property owner must somehow divine, through clairvoyance or otherwise, whether it will be acting in bad faith if any of the terms may be "repugnant" to the pre-emptioner's right of first refusal.

Of course, there will be clear-cut factual situations where it will be obvious that the property owner created non-price terms designed to defeat the pre-emptioner's right. But there will certainly be a number of cases where the pre-emptioner may be able to use the prospect of litigation to force the property owner to offer "vanilla" non-price terms that may work to the disadvantage of the property owner in an open market system and of marginal, if any, benefit to the pre-emptioner.

For example, suppose at the time of the creation of the pre-emptive right the property in question is slated for commercial development. Later, as part of the terms of the triggering offer, the property owner desires to impose commercially reasonable restrictive covenants on the property (such as architectural control and customary use restrictions) at the time of closing. Would such a deal term be repugnant to a pre-emptioner who is in favor of the commercial development but who may disagree with the scope of one or more of the proposed covenants? What if the pre-emptioner has a reputation for, or practice of, developing commercial properties without restrictive covenants? With *Bramble* as support, would the pre-emptioner have the leverage in the negotiations at that point? Could the pre-emptioner strike a more favorable deal than otherwise would be the case had the pre-emptive right not existed in the first place?

Another example is where a property owner grants a third party a right of entry to conduct physical examinations of the property and review title before entering into a contract of sale. Once the third party satisfies itself as to the physical condition of the property and the condition of title, the property owner and third party then enter into a contract of sale that contains no provisions granting the buyer a study period or an opportunity to review title and perform a survey. In essence, the contract is predicated on a "sign and close" model.

In that situation, the pre-emptioner would have no opportunity to conduct customary due diligence investigations of the property and would be forced to close immediately. Based on these assumptions, could the pre-emptioner prevail in a claim that the property owner and third party so structured the contract in bad faith for the purpose of dissuading the pre-emptioner from exercising its right of first refusal? The property owner and the third party may have had valid business reasons for structuring the contract in this manner, but they will need to show reasonable justification for this structure.

Finally, it is interesting to note in passing that Bramble ultimately determined that the mining prohibition was evidently not repugnant to its interests. Indeed, Bramble resubmitted its offer containing the mining prohibition.

Conclusion

Real estate practitioners will need to re-visit their forms to determine how best to revise their right of first refusal provisions in light of *Bramble*. Although the case-by-case analysis advanced by the *Bramble* court is reasonable, it would not be surprising if it spawns increased litigation and uncertainty.

One less reasonable alternative would have been to create a fraud standard, which would have increased the pre-emptioner's burden of proof to establish that the property owner defrauded the pre-emptioner from a valuable property right. But the *Bramble* court needed to strike a balance, and the resulting rule is perhaps the best under the circumstances.

Kevin L. Shepherd is the co-chair of the Real Estate Practice Group of Venable LLP. He is the Immediate Past Chair of the ABA Section of Real Property, Probate and Trust Law, is an officer of the American College of Real Estate Lawyers, is a member of the American College of Mortgage Attorneys, and is a governor of the Anglo-American Real Property Institute.