

## Right of First Refusal in Lease

In the recent California decision in *Smyth v. Berman*, considering an issue of first impression, the Court of Appeal framed the issue: Does a right of first refusal contained in a written lease expire when that leasehold ends and the tenant becomes a “holdover” tenant, and when the lease specifies “the continuing [holdover] tenancy will be from month to month”?

The Appellate Court concluded that a right of first refusal is not an essential term that carries forward into a holdover tenancy unless the parties so indicate. Because there was no such indication in the case, the dismissal of the Tenant's case was affirmed.

This case illustrates the significance of certain legal and drafting issues that need to be considered in every lease that includes a right of first refusal for the tenant to purchase the property.

In *Smyth*, after entering into a lease in 1999, the Owner and Tenant entered into a 2011 Lease that by its terms was set to expire on December 15, 2012, but contained an option to renew the lease for an additional three year term. The lease also granted Tenant the right to make “alterations and improvements” to the Property and to sublet the Property as long as they obtained Owner’s consent. The 2011 Lease further provided: “If the Tenant remains in possession after this lease ends, the continuing tenancy will be from month to month.”

In each of the two written leases, Tenant inserted a handwritten term granting him an option to purchase the Property. In the 1999 lease, Tenant wrote in “first option to purchase”. In the 2011 Lease, Tenant wrote in “Right of 1st refusal to purchase.” The parties initialed the addition to the 2011 Lease.

After Owner accepted an offer to purchase the Property from a third party, and rejected Tenant's claim to exercise the right of first refusal and offer to purchase in August 2016, the Tenant sued the Owner for (1) specific performance of the right of first refusal, (2) breach of contract for not honoring the right of first refusal, and (3) intentional misrepresentation and fraud on the ground that the Owner never had any “intention of fulfilling the right of first refusal.

Tenant filed an amended complaint adding four new defendants— Owner’s real estate agent, the agent’s broker, the third party, and the third party's

business partner. Tenant modified the intentional misrepresentation and fraud claim to add an additional allegation—namely, that Owner had lied to Tenant about the cancellation of the third party offer. Tenant also added six new claims: (1) tortious interference with the contractual relations between Tenant and Owner (against Owner’s real estate agent, the broker, third party, and Owner); (2) negligence (against the real estate agent and broker); (3) cancellation of instruments due to fraud (against the real estate agent, third party and third party's business partner); (4) civil conspiracy (against Owner, the real estate agent, the broker, and third party); (5) declaratory relief; and (6) quiet title.

The trial court ruled that Tenant possessed no right of first refusal at the time of the Tenant's August 2016 offer because:

(1) Tenant was a “holdover” tenants by August 2016 because the 2011 Lease—even if extended by three years—had expired on December 16, 2015; and

(2) the right of first refusal contained in the 2011 Lease did not carry forward as a term of the “holdover” tenancy.

The trial court also ruled that a right of first refusal did not exist in August 2016 by virtue of an oral extension of the 2011 Lease because:

(1) such an oral extension was invalid under California's statute of frauds because the December 2015 letter signed *by Tenant* did not satisfy the statute’s requirement of a writing “signed by Owner or his agent” and because the other, unspecific writings did not reference any right of first refusal, and

(2) Owner was not estopped from asserting the statute of frauds as a defense because none of the actions Tenant alleged as detrimental reliance—paying rent, making improvements or buying the property next door—happened “after or because of the alleged December 2015 [oral] extension.”

On appeal, Tenant alleged three theories for a valid right of first refusal in August 2016:

(1) as a holdover tenant after the 2011 Lease expired;

(2) pursuant to an oral extension of the 2011 Lease; and

(3) pursuant to a separate, July 2016 contract that granted Tenant a right of first refusal.

Under California law, when a lease expires but the tenant remains in possession, the “relationship” of the landlord and tenant “changes.” The “lessor- lessee relationship” based on “privity of contract” ends, and a new “landlord”-“tenant” relationship based on “privity of estate” springs into being by the operation of law. (Civ. Code § 1945.) This new “hold-over” tenancy is “presumed” to continue “[under] the same terms” contained in the now-expired lease “except [as those terms] may have been . . . modified” by the landlord and tenant. (Civ. Code, § 1945.)

The *Smyth* case presents the question: If the expired lease contained a right of first refusal, is that right one of the “terms” that presumptively carries forward into the holdover tenancy?

The Court of Appeal answered “no,” for two reasons.

First, the only terms from the expired lease that are presumed to carry forward into a holdover tenancy are the “essential” terms of that lease—that is, the “term[s] or condition[s] of the demise” such as the “amount and time of payment of rent” The California Supreme Court has held that an option to purchase property set forth in a lease was a “separate and distinct right and power” that was *not* an “essential covenant” of that lease, and thus presumptively did not carry forward into a holdover tenancy. This logic applies with equal force to a right of first refusal because the right is a species of option to purchase: It is a *conditional* option that entitles the holder, if the seller decides to sell property and has obtained an acceptable, bona fide offer from a third party buyer, to make an offer that meets or beats the third party’s offer.

The parties to a lease have the power to rebut the general presumption that a right of first refusal does not carry forward into a holdover tenancy by expressing a contrary intent. But Owner and Tenant did not do so in the 2011 Lease, which merely provided that any continuing holdover tenancy will be from month to month. The holdover provision did not incorporate, or even mention, the right of first refusal or, for that matter, any other term of the 2011 Lease.

Second, a rule presuming that rights of first refusal do not carry forward into holdover tenancies furthers the public policy favoring the stability of commercial tenancies. Holdover tenancies *exist* to ensure stability because

they are a mechanism by which tenants may remain in possession without disruption, albeit typically only on a month to month basis. (Civ. Code, § 1945.) If a right of first refusal presumptively carried forward into a holdover tenancy, a landlord wishing to nullify that right could easily do so by evicting the holdover tenant and selling the property one day later, both of which would be within its rights as the landlord of a holdover tenant. This creates an incentive for landlords to evict holdover tenants as soon as possible.

The contrary rule that carries such purchase options forward only if the parties so specify avoids this result, thereby making holdover tenancies more stable.

The statute of frauds provides that any agreement for “the sale of real property, or of an interest therein” is invalid unless it is “in writing and subscribed to by the party to be charged.” (Civ. Code, § 1624, subd. (a)(3).) Because they are a species of an option to purchase, rights of first refusal to purchase real property must satisfy the statute of frauds. To satisfy the “writing” requirement of the statute of frauds, the writing may be cobbled together from various documents, but they must still identify the subject of the parties’ agreement, show that they made a contract, and state the essential contract terms with "reasonable certainty".

The allegations that the July 2016 contract was documented in the exchange of four emails between Tenant’s attorney and Owner were insufficient to satisfy the statute of frauds. Owner’s equivocal and non-confirmatory responses do not show that Tenant's counsel and Owner “made a contract” or set forth the “essential contract terms with reasonable certainty.”

**LESSON:** Whenever a right of first refusal is a provision in a commercial or residential lease, the lease should be specific that the right of first refusal survives the end date of the lease and can be enforced by the tenant so long as the tenant is a holdover tenant from month to month, and the provision is an essential term that carries forward into the holdover tenancy. This language will enable the tenant to exercise and enforce the right of first refusal during the entire term of tenancy and lawful occupancy. Of course, the process by which the tenant is required to exercise the right should also be specified, but that is a subject for another article.