

Landlord Makes Itself an Offer It Can't Refuse

BY ALAN NOCHUMSON

Special to the Legal

Leases frequently contain provisions granting the tenant the first right to purchase the leased premises in the event the landlord desires to sell. A right of first refusal should be distinguished from a true option to purchase. In the case of an option to purchase in the landlord-tenant context, the tenant has the right to purchase the leased premises at a set price during all or a part of the lease. In comparison, a first refusal clause requires the landlord, when he wishes to sell the leased premises, to offer the premises first to the tenant at the same price offered by the potential purchaser.

A "sale" must occur in order for the first refusal clause to come into play. In a case of first impression, the Pennsylvania Superior Court in *Lehn's Court Management LLC v. My Mouna Inc.* recently examined whether a transfer of real property from a corporate landlord to its sole shareholder amounted to a "sale," thus triggering a tenant's right of first refusal.

Several years ago, Lehn's Court Management entered into a lease agreement containing a first refusal clause. The clause specifically provided that if the landlord, My Mouna Inc. and Chicken George's Palace Inc., received or made an offer to sell the leased premises, they needed to give Lehn's the opportunity to match the proposed offer. On the same day that the lease was executed, the parties also signed a memorandum of right of first refusal, which reiterated the terms of the first refusal clause contained in the lease.

When George Moussa, the sole shareholder of both corporate landlords, transferred title of the leased premises to himself for \$60,000 without giving Lehn's the opportu-



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nity to purchase the premises for itself, Lehn's filed suit alleging that the transfer was in derogation of its right of first refusal.

The lower court subsequently dismissed the complaint, finding that the transfer from the corporate entities to its sole shareholder did not constitute a "sale" within the contemplation of the first refusal clause contained in the lease. The trial court's decision was then appealed to the Superior Court.

The court analyzed the policy reasoning behind first refusal clauses in the landlord-tenant context. From the outset, the court noted that "[i]t is a valuable right that the tenant holds and is the result of a bargained-for exchange." The court explained that while the tenant cannot be forced to purchase the leased premises by agreeing to such a clause, the clause gives the tenant the first chance to purchase the premises before the landlord sells the premises to a third party.

The court also examined how Pennsylvania appellate courts have historically dealt with similar issues regarding transfers in the face of first refusal clauses. The court first discussed the Pennsylvania Superior Court's ruling in *Mericle v. Wolf*. In *Mericle*, the Superior Court held that a gratuitous transfer of real property to a hospital did not trigger a tenant's right of first refusal. The Superior Court, applying general contract principles, found that the clause was intended to give the tenant the right of first

refusal if the property was sold. Since the transfer was by way of a gift instead, the Superior Court reasoned that the right of first refusal never came into play. In so holding, the Superior Court rejected the tenant's argument that the underlying purpose of the first refusal clause was for the protection and continuation of his business, and the transfer of the property, whether by gift or sale, defeated

that purpose.

The *Lehn's* court then compared the Superior Court's decision in *Mericle* to the Pennsylvania Supreme Court's holding in *Warden v. Taylor*. In *Warden*, a landowner gifted farmland to her grandson in spite of the existence of the first refusal clause. However, unlike *Mericle*, the Supreme Court

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in *Ward* concluded that the transfer was improper because the first refusal clause in *Ward* was triggered by conveyance alone, which occurred when the land was transferred from the landowner to her grandson.

The Superior Court nevertheless found that the facts and circumstances in *Lehn's* differed from *Mericle* and *Warden* in three respects. First, the transfer was in name only because the sole shareholder remained in control of the property despite the change in ownership. Second, the transfer was not by way of gift but rather for a substantial amount of money. Third, the first refusal clause was contingent on the landlord receiving or making an offer.

The Superior Court then reviewed how other jurisdictions have handled similar disputes. It first examined state court decisions in Colorado, Rhode Island and New Jersey, which found that a "sale" did not occur. In *Kroehnke v. Zimmerman*, the Colorado Supreme Court was faced with a transfer of property from an individual to his solely owned corporation. The court noted that while consideration was given for the transfer of title, there was "nothing in the record to suggest arm's-length dealing between an owner willing (but not forced) to sell and a buyer willing (but not forced) to buy, which customarily characterizes a sale in the open market." As a result, the court concluded that there was no "sale" between the individual

and his corporation.

The Rhode Island Supreme Court in *Belliveau v. O'Coin* also held that the transfer of land from an owner to her solely owned corporation did not constitute a sale. The court first pointed out that the transfer occurred solely for tax-avoidance reasons, thus indicating that the transaction was nothing like the type of arm's-length transactions found in the marketplace. The court then emphasized that the new landlord was not a stranger to the tenant because the transfer of ownership was in name only.

In *Sand v. London & Co.*, the New Jersey Superior Court dealt with a contested transfer of property that occurred between corporations with both corporations having identical stockholders. The court concluded that no sale occurred because the original owners remained in a position to control and dispose of the property.

After reviewing the cases previously cited, the *Lehn's* court then examined the persuasive effect of the Utah Supreme Court's rationale in *Prince v. Elm Investment Co.* In *Prince*, the landlord entered into a partnership agreement with another company to "acquire, improve, lease and manage" the property, with the landlord retaining 51 percent ownership in the property and the other company holding the remaining 49 percent. The partnership agreement also provided that all decisions and actions of the partnership required unanimous consent of the partners. The *Prince* court, guided by the three state cases previously discussed, found that, for

purposes of a right for first refusal, a "sale" occurs upon the transfer (a) for value, (b) of a significant interest in the subject property, (c) to a stranger to the lease, (d) who thereby gains substantial control over the leased property.

Applying those factors to the case in hand, the *Prince* court found that since the landlord transferred its property interest to an entity unknown to the tenant, and since this stranger could control the lease via the veto power contained in the partnership agreement, a sale occurred because the tenant was, in effect, under new management.

The *Lehn's* court believed that the Utah Supreme Court's definition of "sale" protected the interests of the holder of the right of first refusal and comported with the intent of the leasing parties. The Superior Court pointed out that this type of clause is intended to safeguard a tenant's relationship with the landlord. The court reasoned that if the landlord was going to sell to a third party that the tenant did not care for, the tenant was given ability to purchase the premises by way of the first refusal clause.

The Pennsylvania Superior Court then applied the *Prince* test to the situation at hand. It found that the first two elements of the test were easily met. First, the transfer was for \$60,000, and thus "for value." Second, the corporate landlords did transfer a significant property interest by giving its title in the property to its sole shareholder. The Superior Court nevertheless found that the last two elements of the test were not met

because the new landlord, the sole shareholder, was not a stranger to the tenant. The court concluded that the transfer did not change the tenant's position because the transfer was a change in name and legal entity only and not actual control. The court thus held that a sale did not, in fact, occur.

The Superior Court's recent decision has established rules of engagement for a landlord who wants to transfer his property when a first refusal clause is in play. If the landlord merely transfers the property from himself to another entity he controls, or vice versa, based on the Superior Court's holding, the first refusal clause should have no legal effect on the transfer. The Colorado, Rhode Island and New Jersey cases cited by the Superior Court in its decision support this conclusion.

If, however, the landlord wants to change the ownership structure such that new parties take "substantial control" of the burdened property, then the landlord should give the tenant the right to purchase the property before finalizing the deal. This result merely flows from the Superior Court's reliance on *Prince*. In *Lehn's*, the Superior Court stressed that unlike *Prince*, "there was no stranger who gained substantial control over the property." In the context of first refusal clauses, strangers do not make good bedfellows.

(Copies of the 17-page opinion in *Lehn's Court Management LLC v. My Mouna Inc.*, PICS No. 03-1822, are available from The Legal Intelligencer. Please refer to the order form on Page 11.)