Where wife has title, can bankrupt husband who resides in home and shares expenses make a homestead claim?

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A recent case from the Seventh Circuit highlights the unintended consequences that can result from minor changes in the ownership of real estate when one of the owners or residents files for bankruptcy. In In re Belcher, 551 F.3d 688 (7th Cir. 2008), the U.S. Court of Appeals for the Seventh Circuit held that a husband who was not a titled owner of his residence with his wife was ineligible to exempt part of his interest in the residence as a homestead under Illinois law, even though, at the time of the bankruptcy filing, he undisputedly lived in and intended to continue living in the residence. As this result could occur in many other states, anyone contemplating a "technical" transfer of title to a family member, ex-spouse, family business entity, or trust needs to consider the effects of such a transfer on an individual resident's exemptions in a possible bankruptcy case.

Under nearly all states' laws, outside of bankruptcy, an individual can claim a specified portion of his or her "homestead" (in addition to other property, which is often itemized in state statutes) as exempt from creditors. That portion ranges from a low of $5,000 – though some states have no homestead exemption – to an unlimited dollar amount. Exemption laws vary tremendously from state to state, not just in the amount of each exemption, but also in the language used to grant the exemption, the debts from which the property is exempt, and the liberalness or strictness with which the exemption statutes are construed.

Most Americans' only encounter with exemptions is in bankruptcy. Although exemption law is a patchwork of diverse provisions, the majority of states only permit an individual to claim an exemption against judgment debts, and not against tax debts, voluntary mortgages, or child and spousal support obligations. Because only a fraction of Americans have judgment creditors that do not fall into one of those categories, exemption laws are unfamiliar to most consumers, other than knowing that homestead exemptions in some states (most famously, Texas and Florida) are unlimited in amount.

In bankruptcy, all individual debtors ("debtor" meaning the person who files bankruptcy) are permitted to choose between the exemptions provided by their home state's law and a set of federal exemptions found in the Bankruptcy Code.[1] There can be three possible effects of taking a homestead exemption in a liquidation, or chapter 7, bankruptcy: (1) if the amount of the exemption equals or exceeds the value of the debtor's unmortgaged interest in the homestead, it will prevent the bankruptcy trustee from selling the homestead where the trustee otherwise could, with the debtor's unsecured creditors sharing the proceeds of the unencumbered amount; (2) if the amount of the exemption is less than the value of the debtor's unmortgaged interest in the

[1] 11 U.S.C. § 522(b)(1). A state can "opt out" of the federal exemptions, that is, limit its citizens to the state's exemptions, even in bankruptcy. 11 U.S.C. § 522(b)(2).

homestead, it will entitle the debtor to proceeds of the trustee's sale of the homestead, in the amount of the exemption; and (3) if the value of the debtor's unmortgaged interest in the homestead is zero, there will be no effect (at least in the significant majority of states where a homestead exemption does not apply against a mortgage).

The stated purpose of most states' exemption laws is to prevent the harm that would befall the public interest if creditors could render debtors wards of the state. E.g., In re Ballard, 238 B.R. 610 (Bankr. M.D. La. 1999). To that end, all states have enacted some form of protection of assets that the state legislature determines should not be reachable by judgment creditors. In understanding the debate over whether a nontitled spouse can claim a homestead exemption in bankruptcy, it may be helpful to consider that, outside bankruptcy, an exemption prevents a creditor from reaching property that the creditor otherwise could.

The facts in Belcher were that Keith and Katherine Belcher originally were both titled on the property. They divorced. As part of the divorce, Keith deeded his one-half interest to Katherine, so that she became the sole titled owner. The Belchers reconciled and were remarried. However, Keith was never added back onto the title. At the time of the bankruptcy filing, the Belchers were both living on the premises; the bankruptcy trustee did not dispute that the house was Keith Belcher's primary residence.

Illinois law defines a homestead as an individual's "interest in a farm or lot of land and buildings thereon, a condominium, or personal property, *owned or rightly possessed by lease or otherwise and occupied by him or her as a residence*, or in a cooperative that owns property that the individual uses as a residence." 735 Ill. Comp. Stat. § 5/12-901 (emphasis added). When the Belchers' bankruptcy case was filed, each individual could claim up to $7,500 of equity in his or her homestead as exempt, with a maximum per property of $15,000.

The court first reviewed the nature of a nontitled spouse's interest in real property. Keith Belcher arguably had a potential equitable interest in the house that would vest upon Katherine's death or their divorce. But the court, applying case law from Illinois state courts, held that the word "otherwise" in the statute encompassed only "formalized possessory property interests other than outright ownership or leases, such as a life estate." 551 F.3d at 691. Accordingly, the property was not Keith Belcher's homestead.

Whether this result would obtain in other states or under the federal exemption law is a function of how the applicable exemption law is phrased and interpreted. As implied above, there is no such thing as a "one size fits all" discussion of state exemption laws. Nevertheless, a majority of exemption laws fall into one of two categories, and the remainder can likewise be grouped by the language used to create the exemption. While courts in different jurisdictions give different meanings even to laws that are similar to each other, the following framework indicates which exemption laws have the greatest likelihood of being interpreted in a manner similar to the Belcher holding.

A plurality of states grant an exemption to a homestead that is "owned and occupied" by a judgment debtor. For example, in Kansas, "[a] homestead to the extent of

160 acres of farming land, or of one acre within the limits of an incorporated town or city, or a manufactured home or mobile home, occupied as a residence by the owner or by the family of the owner, or by both the owner and family thereof, together with all the improvements on the same, shall be exempted from forced sale under any process of law. . . ." Kan. Stats. § 60-2301.[2] On its face, this exemption appears susceptible to the same result as in Belcher: a court might find that a nontitled spouse is not an "owner" of property.

Many other states, as well as the Bankruptcy Code, exempt interests in property that a judgment debtor uses as a residence. In South Carolina, for example, "[t]he following real and personal property of a debtor domiciled in this State is exempt from attachment, levy, and sale under any mesne or final process issued by a court or bankruptcy proceeding: (1) The debtor's interest, not to exceed twenty-five thousand dollars in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence. . . ."[3] S.C. Code § 15-41-30(A)(1). A variation on this theme is the statute at issue in Belcher, 735 Ill. Comp. Stat. 5/12-901, which provided: "Every individual is entitled to an estate of homestead to the extent in value of $7,500 of his or her interest in a farm or lot of land and buildings thereon, a condominium, or personal property, *owned or rightly possessed by lease or otherwise and occupied by him or her as a residence.*"[4]

Having an interest in property encompasses a greater variety of potential interests in property than owning it does. Practically, though, few individuals will have a valuable interest in property that is less than a fee simple interest.[5] The stated facts in Belcher were that a husband conveyed his half-interest in property to his wife, then later returned. But what the court never explored (possibly because the pleadings did not raise it) was the *capacity* in which Keith Belcher returned to the property. He likely was a tenant at will or at sufferance. It is possible but not probable that the Belcher holding would have been different had the court determined that Keith Belcher's interest was one of those

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[2] See also, e.g., Ark. Const. Art. 9 § 5; Colo. Rev. Stats. § 38-41-201(1)(a); Conn. Gen. Stats. § 52-352a(e); Idaho Code § 55-1001(4); La. Rev. Stats. § 20:1(A)(1); Mich. Comp. Laws § 600.5451(5)(d); Minn. Stats. § 510.01; Miss. Code § 85-3-21 (applies only to "householder"); N.M. Stats. § 42-10-9; N.Y. C.P.L.R. § 5206(a); 31 Okla. Stats. § 2(C) (split--within cities and towns only); Tenn. Code § 26-2-301(a); 27 Vt. Stats. § 101; Rev. Code Wash. § 6.13.010(3); Wis. Stats. § 815.20.

[3] See also, e.g., Alaska Stats. § 09.38.010(a); Ariz. Rev. Stats. § 33-1101(A)(1); 10 Del. Code § 4914(c)(1); D.C. Code § 15-501(a) (applies only to head of a family or householder); Ga. Code § 44-13-100(a)(1); Hawai'i Rev. Stats. § 651-92(a)(1) (applies only to head of household); 735 Ill. Comp. Stat. 5/12-901 (at issue in Belcher); 14 Me. Rev. Stats. § 4422(1)(A); N.C. Gen. Stats. § 1C-1601(a)(1); Nev. Rev. Stats. §§ 21.090(2), 115.01(2); Savage v. Pierson, 157 P.3d 697 (Nev. 2007) (homestead exemption only protects "equity," a term which does not include possessory interests or security deposit under residential lease); Ohio Rev. Code § 2329.66(A)(1)(b); W. Va. Code § 38-10-4(a).

[4] See also, e.g., Ala. Code § 6-10-2; Mass. Gen. Laws 188 § 1; Tex. Prop. Code §§ 41.001(a), 41.002; In re Perry, 345 F.3d 303 (5th Cir. 2003) (Texas homestead consists of debtor's interest in property, but not more--meaning debtor can exempt interest as at-will tenant, to extent of tenancy's value).

[5] Most life estates in residential real property, for instance, have little value to anyone other than the remainderman. A bankruptcy trustee would likewise be hard-pressed to sell the debtor's interest as tenant under a long-term lease for an amount greater than even the smallest homestead exemption. Even if the trustee could find a buyer for such an interest, most debtors would probably prefer a $5,000 or greater cash payment to staying on the property.

types of tenancies. On the one hand, the court did unambiguously declare that only "formalized" interests in real property were intended by the word "otherwise" in the exemption statute. On the other hand, this statement was a holding only as applied to the types of future or potential equitable interests discussed in the case, and arguably would be a dictum as to other interests such as tenancies at will and at sufferance.

In contrast, it is unlikely that a case like Belcher would be decided under exemption laws that focus solely on whether the debtor uses the property as his or her principal residence. Montana's exemption statute provides: "The homestead consists of the dwelling house or mobile home, and all appurtenances, in which the claimant resides and the land, if any, on which the same is situated, selected as provided in this chapter."[6] Mont. Code § 70-32-101. Unlike Illinois' statute, these states' exemption laws do not limit homestead exemptions to "interests" in property, let alone ownership interests in property.

A variation on the Montana statute that defines homesteads as primarily based on residence, but also mentions ownership, poses a closer question. Missouri's statute, for example, defines homestead as "a dwelling house and appurtenances . . . which is or shall be used by such person as a homestead." Mo. Stats. § 513.475(1). However, the very next sentence reads, "The exemption allowed under this section shall not be allowed for more than one *owner* of any homestead if one *owner* claims the entire amount allowed under this subsection. . . ." Id. A court might view the primary definition as ambiguous (if not outright circular) and find the repeated uses of the word "owner" in the subsequent sentence as indicative of legislative intent to limit homesteads to ownership interests. In that event, a result like Belcher could obtain in Missouri and states with similar exemption statutes.[7]

Finally, in some states, the amount of an exemption for a married couple is less than double the amount of a single person's exemption, reducing – and sometimes eliminating – the need to litigate the rights of a nontitled spouse. Compare, e.g., Ala. Code § 6-10-2 ($5,000 per person; $10,000 per married couple) , with Tenn. Code § 26-2-301(a) ($5,000 per person; maximum of $7,500 per pair of joint owners), with Ariz. Rev. Stats. § 33-1101(A)(1) ($150,000 per person or per married couple). The question in Belcher would be moot if adding a spouse to the title would not increase the exempt amount.

Belcher is a stark example of the potential for unforeseen consequences in seemingly innocuous decisions involving real estate (and other property) in a future bankruptcy. In the Belchers' minds, a divorced man was moving back in with his ex-wife. Undoubtedly, it never occurred to the Belchers that the lack of formal documentation of this arrangement would cost them thousands of dollars. Real estate, family law, and probate practitioners are accustomed to anticipating the problems these decisions can cause in subsequent deaths and divorces. Belcher suggests that subsequent bankruptcies should be on that list, too.

[6] See also N.D. Cent. Code § 47-18-01.
[7] E.g., Neb. Rev. Stats. § 40-101.

UPDATE ON THE AMENDMENTS TO FAS 140—ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS AND REPURCHASE FINANCING TRANSACTIONS

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I. Background

The Financial Accounting Standards Board ("FASB") has continued to progress in its amendments to FAS 140[2], *Accounting for Transfers and Servicing of Financial Assets and Extinguishing Liabilities*. The Board has recently adopted rules that eliminate special purpose entities as an accounting tool, which will in turn affect how banks account for off-balance-sheet entities.

a. The FASB: Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting.[3] These standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.[4]

b. FAS-140: Financial Accounting Standards, or FAS 140 govern the accounting rules for transfers and servicing of financial assets. FAS 140 was originally implemented in September of 2000. It replaced the old FASB Statement No. 125 and revised the standards of accounting for securitizations and other transfers of financial assets and collateral.[5] FAS 140 requires certain disclosures, but carried over most of Statement 125's provisions without reconsideration. FAS 140's accounting standards are based on consistent application of a *financial-components approach* that focuses on control.[6] Under this approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred while derecognizing financial assets when control has been surrendered, and derecognizes liabilities when extinguished.[7] Generally, a transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration, other than beneficial interest in the transferred assets, is received in the exchange.

A transferor has surrendered control if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor, and they are presumptively beyond the reach of the transferor and its creditors.

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[2] Financial Accounting Standard 140.
[3] Reuters, FASB Issues Exposure Draft to Amend Statement 140 and Interpretation 46(R) (September 15, 2008), http://www.reuters.com/article/pressRelease/idUS210960+15-Sep-2008+BW20080915
[4] *Id*.
[5] FASB, Summary of Statement No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, http://www.fasb.org/st/summary/stsum140.shtml.
[6] *Id.*
[7] *Id.*

2. Each transferee has the right to pledge or exchange the assets it received, and there is no condition on its right to pledge or exchange.

3. The transferor does not retain control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem the assets before their maturity or (2) the ability unilaterally to cause the holder to return the specific assets.[8]

c. **SPE**: Special Purpose Entities (SPEs), also referred to as off-balance-sheet arrangements, have been in use since the 1970s when companies began engaging in securitization.[9] These off-balance sheet arrangements are called qualifying special purpose entities (QSPEs) if they meet the requirements set forth in FAS 140.[10] In basic terms, an off-balance sheet entity is created by a party, the transferor, by transferring assets to another party, the special purpose entity, to carry out a specific purpose, activity, or series of transactions.[11]

SPEs are created to accomplish three general objectives:

1) Financing certain assets or servicing and keeping the associated debt off the balance sheet of the transferor;

2) Transforming certain financial assets, such as trade receivables, loans, or mortgages, into liquid security; and

3) Engaging in tax-free exchanges.[12]

These off-balance-sheet entities can benefit the transferor in two ways. First, an SPE enables the transferor to remove debt from its balance sheet so it meets certain ratios and loan covenants. Second, such arrangements protect the transferor from possible financial failure by its SPE.[13] Thus, if the project for which an SPE was created fails, the transferor is at risk only for what it has put into the SPE. In addition, these SPEs enable the transferor to add more debt, some of which could be risky.

Again, the SPEs' main functions are in the area of securitization. Securitization is a process by which securities are created whose payments are supported by cash flows generated by a pool of financial assets.[14] This process provides funding to the marketplace, thereby helping to ensure that consumers can obtain the necessary credit.[15] SPEs in securitization simply

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[8] *Id.*
[9] Jalal Soroosh and Jack T. Ciesielski, Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R), The CPA Journal, http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm.
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.* It should be noted that the transferor will also have to remove from its balance sheet the assets related to the debt that has been moved to the SPE.
[14] Special Purpose Entities (SPEs) and the Securitization Markets (February 1, 2002), http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf.
[15] *Id.*

act as a depository for a specific group of assets in a securitization, and in turn, issue securities to the marketplace for purchase by investors.[16]

FAS 140 as it was originally written in 2000 specifically defined a qualifying SPE as a trust or other legal vehicle that meets all of certain specific conditions.[17]

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[16] *Id*.

[17] *See* Financial Statements of Accounting Standards No. 140 (September 2000), http://fasb.org/pdf/fas140.pdf:

35. A qualifying SPE is a trust or other legal vehicle that meets *all* of the following conditions:

a. It is demonstrably distinct from the transferor (paragraph 36).

b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).

c. It may hold only:

(1) Financial assets transferred to it that are passive in nature (paragraph 39)

(2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)

(3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE

(4) Servicing rights related to financial assets that it holds

(5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)

(6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)

(2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)

(3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51–54 and 85–88)

(4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

II. Amending FAS 140

As QSPEs and SPEs became more commonplace, their structure and use became more sophisticated. As a result, the accounting standards dealing with off-balance-sheet entities produced inconsistent results as the standards were incomplete and fragmented.[18]

In the wake of the Enron scandal, which brought to light the use of SPEs as a tool to enhance a company's bottom line, FASB responded by issuing a proposed interpretation of existing accounting principles aimed at putting many off-balance-sheet entities back onto the balance sheet of companies that had created them.[19] In June of 2002, the FASB issued an exposure draft to revise accounting for SPEs.[20] Beginning in January of 2003, the FASB expanded its project to examine amending FAS 140, focusing on the permitted activities of a qualifying SPE and other practices that may permit a transferor to derecognize a financial asset.[21] In August of 2005, the FASB issued an Exposure Draft regarding proposed amendment to Statement 140. A total of 53 comment letters were received from respondents to the Exposure Draft. The majority of respondents generally objected to the changes proposed by the Exposure Draft.[22] As a result of these comments, the Board decided to redeliberate significant issues raised by respondents prior to the issuance of a final amendment.[23] Again, the general focus of this initial amendment was to address the permitted activities of a qualifying SPE.[24]

Beginning in the fall of 2008, in light of the sub-prime mortgage crisis, FASB had decided to eliminate the qualifying special purpose entity. In discussing this issue in a joint meeting with FASB and its European counterpart, the International Accounting Standards Board, FASB Chairman, Robert Herz, explained that the "vehicles into which riskier loans had been packaged were 'ticking time bombs.'"[25]

On September 15, 2008, the FASB issued three separate but related Exposure Drafts for public comment.[26] These proposed amendments impose disclosure requirements on non-

[18] Jalal Soroosh and Jack T. Ciesielski, "Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R), The CPA Journal, http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm.
[19] *Id.*
[20] *Id*.
[21] *See* FASB, http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process.
[22] The respondents who objected generally called for a clarification on issues that concerned the use of QSPEs. *See* Ed Zwrin, FASB To Propose QSPE Killoff, Markets Media Online (March 13, 2008), http://www.marketsmediaonline.com/archive.htm?wP=1&wPI=1.
[23] *Id.*
[24] *Id.*
[25] *Id*.
[26] *See* Revised Exposure Draft for Proposed Statement for Financial Accounting Standards, http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf. Furthermore, the three drafts are: The proposed FASB Statements, Accounting for Transfers of Financial Assets, and Amendments to FASB Interpretation No. 46(R), address amendments to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and to FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. Proposed FASB Staff Position FAS 140-e and FIN 46 (R)-e, Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities, address related disclosure requirements for public entities.

transferors and eliminate the QSPE itself as an acceptable accounting practice.[27] The proposed amendments to FAS 140 can be summed up as follows:

1. The amendments would remove the concept of a qualifying SPE from Statement 140 and would remove the exception from applying Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, to qualifying SPEs.

2. The amendments would clarify that the objective of paragraph 9 of Statement 140 is to determine whether a transferor and all of the entities included in the financial statements being presented have surrendered control over transferred financial assets. This determination must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

3. The amendments would define the term *participating interest* to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. If the transfer does not meet those conditions, sale accounting could be achieved only by transferring an entire financial asset or a group of financial assets that meet the derecognition criteria in paragraph 9 of Statement 140, as amended.

4. The special provisions in Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, for guaranteed mortgage securitizations would be removed to require them to be treated the same as any other transfer of financial assets within the scope of Statement 140, as amended. If such a transfer does not meet the requirements for sale accounting, the securitized mortgage loans would continue to be classified as loans.

5. The use of fair value measurements would be increased because the proposed amendments would require a transferor's beneficial interests to be considered an asset obtained as proceeds that is initially measured at fair value when the transfer is accounted for as a sale. The amendments also would eliminate the fair value practicability exceptions in Statement 140.

6. Enhanced disclosures would be required to provide users of financial statements with greater transparency about transfers of financial assets and a transferor's continuing involvement with such transferred financial assets.[28]

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[27] Ed Zwirin, FASB to Tackle QSPEs, Market Media Online (December 16, 2008), http://www.marketsmediaonline.com/news_details.htm?wP=11&wPI=1&cN=2536.
[28] *See* Revised Exposure Draft for Proposed Statement for Financial Accounting Standards 140, http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf.

The FASB received a total of 48 comments regarding the amendments to FAS 140.[29] Regarding comments related to QSPEs, there was a general feeling of support for the removal of the QSPEs;[30] however, there were also general concerns over the effect and effectiveness of such elimination.[31]

III. FASB Board Decisions

At an April 1, 2009 Board Meeting, the FASB reached the following pertinent decisions during redeliberations of the 2008 Exposure Draft:[32]

I. FASB affirmed the following provisions of the Exposure Draft on accounting for transfers of financial assets:

a. Removal of the concept of a qualifying-special purpose entity.

b. The requirement that a transferor consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

c. Implementation guidance on isolation.

d. Removal of special provisions for guaranteed mortgage securitizations.

e. The measurement of beneficial interests and participating interests in transfers accounted for as sales.

f. The measurement and classification of interests (including security interests) in the transferred financial assets received by the transferor when a transfer does meet the criteria for sale accounting.

II. FASB affirmed the definition of participating interest with the following changes:

a. Remove the proposed exception to participating interests for transfers of portions of equity instruments, derivative financial instruments, and hybrid financial instruments with an embedded derivative that is not clearly and closely related, as described in FASB Statement No.133, *Accounting for Derivative Instruments and Hedging Activities.*

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[29] Copies of recent Comment Letters to the Proposed Amendments to FAS-140 can be found at http://www.fasb.org/ocl/fasb-getletters.php?project=1610-100; A general summary of these Comment Letter can be found at http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf.

[30] FASB, Transfers of Financial Assets Comment Letter Summary, http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf.

[31] *Id.*

[32] FASB, http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process (the conclusions discussed herein were taken directly from the FASB website).

b. Exclude from the determination of proportional cash flows the cash flows related to (1) the origination of financial assets, (2) effectuating the transfer of the financial assets, and (3) servicing the financial assets.

c. Clarify that third-party guarantees should not be considered in the evaluation of whether the participating interest definition is met.

d. Clarify that, in the event of bankruptcy or receivership of the transferor, set-off rights of the borrower do not preclude meeting the definition of a participating interest.

e. Clarify that a financial instrument that is legally a single contract is considered an individual financial asset. For example, a loan transferred to a special purpose entity before securitization should be considered an individual financial asset. In addition, a beneficial interest (in the loan) issued after the securitization process has been completed should be considered an individual financial asset.

f. Clarify that transfers of portions of a financial asset that do not individually qualify for sale accounting because they do not meet the participating interest definition, but result in the transferor transferring all of the interests in the original financial asset, should be derecognized when all portions of the financial asset have been transferred.

III. FASB also decided not to provide an exception to the definition of a participating interest for transfers in situations in which the transferor retains a non-prorata senior interest in the financial asset.

IV. FASB decided to retain the existing language in paragraph 9(b) of Statement 140, but to remove the notion of a qualifying special purpose entity from that paragraph. The Board decided to require look-through provisions to consider the abilities of the beneficial interest holders to pledge or exchange their beneficial interests when the transferee entity is a special purpose entity involved in a securitization or asset-backed financing arrangement.

V. FASB decided to amend Statement 140 to require that the application of paragraphs 9(b) and 9(c) consider the transferor's relationship with the transferred financial asset and any involvements with beneficial interest holders in securitized financial assets.

VI. FASB decided that a transferor should not account for the transfer of a financial asset as a sale if the transferor retains effective control over all or a portion of the transferred financial asset or group of financial assets being evaluated for derecognition as a single unit.

VII. FASB decided that a transferor must record a portion of a transferred financial asset as a purchase in certain cases in which a subsequent change to the portion causes the transferred portion to no longer meet the criteria of a participating interest (see paragraph 55 of Statement 140).

VIII. FASB redeliberated significant issues related to the disclosures required in the proposed amendment to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and made the following decisions:

a. The proposed disclosures would be updated to reflect the results of the Board's redeliberations of FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities.*

b. The scope of the proposed sensitivity analysis disclosures would be finalized as proposed and would not be expanded.

c. The Board previously decided to require specific disclosures for securitization and asset-backed financing arrangements where a transferor has continuing involvement with transferred financial assets accounted for as sales. The Board decided to expand those requirements to all transfers of financial assets accounted for as sales where the transferor has continuing involvement with transferred financial assets.

d. All disclosure requirements would apply to both nonpublic and public entities.

e. An entity would disclose the nature of any beneficial interests received as proceeds from a sale of financial assets, and also disclose the inputs and valuation techniques used to value those beneficial interests.

f. An entity would disclose the maximum exposure to loss arising from its continuing involvement, except in the case of a secured borrowing.

g. Further guidance on how to consider materiality or significance in relation to continuing involvements would not be provided.

h. The reporting entity would not be required to disclose standardized categories of transferred financial assets in standardized tabular formats.

i. An entity would not be required to disclose an analysis of the maturity of its repurchase obligations.

j. An entity would not be required to disclose the amount of transfer activity (that qualifies for derecognition) in a reporting period when the transfer activity is not evenly distributed throughout the reporting period.

XIV. Finally, FASB has decided to deliberate at a future meeting issues related to transition guidance and effective date.

The final standards are set to be issued in June 2009. Generally, the approved standards will be effective as of the beginning of 2010 and will apply to existing entities, including existing qualifying special purpose entities. However, the amendments on how to account for transfers of financial assets will apply prospectively to transfers occurring on or after the effective date.[33]

IV. Conclusions

Since the fallout from the Enron scandal, FASB has been looking into amending FAS 140. As a result of the recent subprime mortgage crises, the FASB has been on a fast track to remove use of QSPEs as an acceptable accounting practice. The fact these new accounting standards have finally been adopted should not come as a surprise to banks and financial institutions.

But what do these new accounting standards mean for banks and other lending institutions? The rule change clearly would make it harder and costlier for banks and other lending institutions to package and sell off mortgage loans.[34] The QSPE, the vehicle which has allowed Banks to accomplish this, would no longer be a viable option. As a result, borrowing could become more expensive for consumers and companies.[35] Furthermore, banks will have to use other rules governing off-balance-sheet vehicles to account for them and these additional rules are currently and likely to be tightened as well.[36] As a result, this will likely provide additional work for CPAs. To put the impact of a change in perspective, "At the end of 2007, J.P. Morgan Chase & Co. and Citigroup Inc. had nearly $1 trillion in assets held off their books in special securitization vehicles. J.P. Morgan generated nearly $3.5 billion in revenue, or about 6% of total 2007 net revenue, from administering special securitization vehicles."[37]

The other possible result of these amendments is that banks and other companies might be forced to bring billions of dollars worth of assets and liabilities back on their balance sheets, which in turn could trigger new capital requirements.[38] These additional capital requirements result from the regulatory requirement that banks hold a certain amount of capital in reserve to protect investors, and this reserve amount is based on the assets carried on the bank's balance sheet.[39] As a result, more assets on the balance sheets would mean more reserves.

Of course the upside to these accounting changes is that they will hopefully prevent the abuses that have led to billions of dollars of losses over the past year.[40] These new accounting principles would hopefully increase transparency within lending institutions, as well as provide a

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[33] FASB, Briefing Document: FASB Statement 140 and FIN46(R), http://www.fasb.org/news/051809_fas140_ and_fin46r.shtml.
[34] David Reilly, FASB Signals Stricter Rules For Banks' Loan Vehicles, The Wall Street Journal Online (May 2, 2008), http://online.wsj.com/article_print/SB120969084241961495.html.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] Cormick Grimshaw, FASB's new QSPE Rule Implementation Delayed, Market Pipeline (July 30, 2008), http://marketpipeline.blogspot.com/2008/07/fasbs-new-qspe-rule-implementation.html link]
[39] *Id.*
[40] David Reilly, FASB Signals Stricter Rules For Banks' Loan Vehicles, The Wall Street Journal Online (May 2, 2008), http://online.wsj.com/article_print/SB120969084241961495.html.

more realistic portrayal of a lending institution's debt level, borrowing capacity and overall risk. Finally, they should allow third parties to better gauge the appropriate value of a company.

We will continue to monitor the implementation of these changes as well as the effect the new standards will have on the financial industry.

Important Links:

1. FASB General Information regarding Amendment to FAS-140:

   http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process

2. Original FAS-140 Adopted in September 2000:

   http://fasb.org/pdf/fas140.pdf

3. Revised Exposure Draft for Proposed Amended to FAS-140:

   http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf

4. Comment Letters to the Proposed Amendments to FAS-140:

   http://www.fasb.org/ocl/fasb-getletters.php?project=1610-100

5. General summary of Comment Letters to the Proposed Amendments to FAS-140:

   http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf.

Options and Related Rights With Respect to Real Estate: Carveouts for Specific Transactions

By John C. Murray

I. Introduction

If they are not careful, the parties to legal documents creating or transferring real property interests (including leases and purchase agreements) who wish to incorporate options to purchase, rights of first refusal or similar rights, can create unanticipated problems when negotiating and drafting such provisions. Options and related rights should never be taken lightly, and should be clearly and comprehensively negotiated and drafted to reflect the intentions and expectations of the parties. The parties who have granted (and perhaps, in certain cases, those who have been granted) any option, right of first refusal, or similar rights should be careful to carve out from such rights any transactions intended to be excluded, such as: a transfer of property between a parent and a subsidiary corporation or other affiliated entities; a transfer between individuals and an LLC or a partnership formed by them of which they are the sole members or partners (as well as other forms of equity transfers with respect to other entities, such as trusts); foreclosure or deed in lieu of foreclosure; stock transfers, gifts and donations; involuntary taking of the property by government condemnation; transfers of interests between tenants in common; and portfolio or bulk sales of multiple properties (which include the property that is subject to any such right) in a single transaction. This article will review the existing case law in this area, and suggest strategies for eliminating (or at least minimizing) the problems that may occur.

II. Carveouts for Gifts

With respect to gifts and transfers of corporate stock, *see, e.g., Park Station L.P. v. Bosse*, 378 Md. 122, 131-32 (2003). In this case, the court held that absent clear language in the parties' agreement to contrary, first-refusal rights did not apply to a donation of property to a charitable foundation and did not "run with the land" to bind the donee. The court stated that "courts have consistently held that a transfer of property by gift does not trigger a right of first refusal based upon a 'sale' or decision to 'sell.'" *Id.* at 131-32. *See also* 6A C.J.S. Assignments § 37 (Option contracts; rights of first refusal), which states as follows (in connection with the *Park Station L.P.,* decision, *supra)*:

> Rights of first refusal are presumed to be personal, and are thus not assignable unless the clause granting the right refers to successors or assigns, or unless the instrument clearly shows that the right was intended to be assignable. A right of first refusal to purchase real

property is not assignable if the right does not run with the land but is personal to the grantee.

In *Schroeder v. Duenke*, 265 S.W.3d 843, 847-850 (Mo. App. 2d 2008), the owners of the property sold and conveyed it to the purchasers pursuant to a warranty deed. Shortly after the deed was recorded, the parties also separately executed and recorded a first-right-of-refusal document, granting the sellers the first right of refusal to repurchase the property upon certain terms and conditions. Several years later, the purchasers conveyed the property to their son for less than the appraised value of the property ($125,000, obtained by appraisal at the time of the conveyance to the son) without notifying the original sellers, as the holders of the right of first refusal, that they had sold the property to their son. Although it acknowledged that the transfer was not a gift (or "akin to a gift") because the son paid $85,000 for the property and financed $60,00 of the price through a bank mortgage, the appellate court denied summary judgment in favor of the holders of the right of first refusal and remanded the case for a determination of whether the son's offer was in fact a "bona fide offer" -- *i.e.*, the fair market value of the property based on the court's review of evidence to be submitted to it on this issue. The court noted that under Missouri law, a transfer of property by true gift (without any consideration) from one family member to another does not trigger a right of first refusal. For a more thorough discussion of the *Schroeder v. Duenke* case, *see* Harrison Ominsky, *Right of First Refusal – Impairing Family Gift*, 38-MAR REAL EST. L. REP. 3 (2009).

For examples of other court decisions regarding gifts (including gifts of corporate stock), *see Mericle v. Wolf and Sacred Heart Hospital*, 386 Pa. Super. 82, 88-89 (1989) (holding that all elements for a valid *inter vivos* gift were present and that transfer was not a "sale" because a "sale contemplates a vendor and a buyer and the transfer involves payment or a promise to pay a certain price in money or its equivalent." The appellate court concluded that the term "sold" should "be given its ordinary meaning, and, therefore, the appellees' transfer by way of a gift did not activate the refusal right"); *Cottrell v. Beard*, 69 Ark. App. 87, 91 (2000) (holding that right of first refusal was not triggered by grantees' transfers of their interests as gifts for no consideration, finding no ambiguity and stating that "there is no evidence here that appellees were mere straw persons through whom title was to pass on to someone else for consideration"); *Isaacson v. First Sec. Bank*, 95 Idaho 452, 455 (1973) (father's below market "sale" to son was deemed gift that did not trigger first refusal right); *LaRose Market v. Sylvan Center, Inc.*, 209 Mich. App. 201, 207-08 (1995) (holding that sale of corporate stock, as opposed to sale of the real property owned by corporation, would not trigger right of first refusal).

The foregoing cases illustrate the desirability of clearly expressing the intentions of the parties with respect to such transfers in the provisions providing for an option or related right with respect to the property.

III. Carveouts for Transfers of LLC Interests

With respect to transfers of individual interests to LLCs, *see Evans v. S.C. Southfield 12 Associates, LLC*, 298 Fed. Appx. 403 (C.A.6 (Mich.), 2006). In this case, the court noted that "Michigan courts have held that a contract provision containing a right of first refusal must be interpreted narrowly." *Id*. at 407. The court ruled that the property owners' intention to transfer their interest in commercial property to their LLC, of which they were the sole owners, and where the membership interests were in the same proportion as their existing ownership interests, for no monetary consideration, did not constitute a "desire to sell" in connection with "a bona fide written offer" to purchase the property and did not trigger the tenant's first right of refusal under the lease. The court reasoned that such a right would only apply if the landlord, as the property owners' successor-in-interest, desired to sell the property and received a bona-fide written offer to purchase it. The court found that in this case the transfer was not supported by valuable consideration, there was no written offer of purchase from the LLC, and the motive for transfer was not to deprive the tenant of its right of first refusal. The court further ruled that even if the transfer to the LLC constituted a "bona fide written offer," the transfer was contractually exempt from the right of first refusal because the lease stated that it did not apply in the event of the landlord's sale or transfer to any of its officers, directors, and principal shareholders, or to any corporations and/or other entities in which the landlord had any substantial interest. The court stated: "It is beyond dispute that the proposed transfer of interest from the Evans to [the new LLC] was not the result of arms-length dealing and would not result in any real change in control of the property." *Id.* at 408. The court cited several cases from other jurisdictions (Michigan never having specifically addressed the issue) holding "that the transfer of interest from individual owners to another entity controlled by those same individuals does not constitute a 'sale' that triggers a right of first refusal." *Id.* at 407. The *Evans* case clearly highlights the importance of clear and concise drafting of the first right of refusal, as the plaintiff in that case (the tenant) claimed that it should be able to purchase the real property for nothing! (Thereby matching the "consideration" paid by the existing owners for transferring the property to the LLC.)

But see Gebhardt Family Restaurant, L.L.C. v. Nation's Title Ins. Co. of New York, 132 Md. App. 457 (2000). In this case, the court held that a transfer of land from two family members to an LLC, of which they were the only members, terminated coverage under a title insurance policy naming the individual family members as the insured parties. The Gebhardts argued that they nonetheless remained insured parties under the title policy because the conveyance was, in effect, to themselves, and therefore they still retained an "interest" in the property. However, the appellate court ruled that "[i]n contrast to a partnership, a limited liability company in Virginia is an entity separate from its members and, thus, *the transfer of property from a member to the limited liability company is more than a change in the form of ownership; it is a transfer from one entity or person to another* (emphasis in text) (citation omitted)." *Id.* at 463. The court held that while the Gebhardts had an interest in the LLC (which was a personal property interest), they no longer had an interest in the real property as the result of their conveyance of the property to the LLC. The court also rejected the Gebhardts' claim that there was no "real" conveyance because the LLC in fact paid no consideration, ruling that the conveyance to the LLC provided the Gebhardts with actual and substantial benefits, including limited liability and estate planning benefits.

IV. Carveouts for Deeds in Lieu of Foreclosure

With respect to deeds in lieu of foreclosure, *see Pelladini v. Valadao*, 113 Cal. App. 4th 1315, 1317 (2003). In this case, the court ruled that the holder of a right of first refusal on real property, which was owned by two sisters as tenants in common, was not triggered when one of the sisters gave the other a deed in lieu of foreclosure of her undivided one-half interest in the property as satisfaction of a note and deed of trust on her interest in the property obtained from the other sister. The court held that the agreement containing the right of first refusal referred to the tenants in common in the conjunctive and the property was referred to in the singular with no mention of the property other than as a whole, therefore indicating that the phrase "bona fide offer for purchase" was intended to be triggered by the sale of the cotenants' combined interest to a third party. The court found that "[t]here was no sale to a third party in this case." *Id.* at 1322.

V. Carveouts for Transfers of Partnership Interests to Individuals

With respect to transfers of partnership interests to individuals, the courts have generally held that they are outside the scope of an option or first-right of refusal provision. For example, in *Hartzheim v. Valley Land & Cattle Co.*, 153 Cal. App. 4th 383 (2007), the court held that the lessor, which was a family-owned partnership, did not trigger the lessee's right of first refusal on the sale of the real property, as contained in lease, when it transferred the property to the partners' grandchildren, because it was not made pursuant to a bona-fide offer for the purchase of the property from a third party (the grandchildren were contingent beneficiaries under the partnership agreement) in an arms-length transaction, and was made for legitimate income-tax and estate-planning purposes. The court stated that "it is the occurrence of both an arms' length transaction and change in control of the property that characterizes a bona fide sale." *Id*. at 393.

See also Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership, 157 Cal. App. 4th 1515 (4 Dist. 2007) (appellate court affirmed trial court's ruling that commercial lease's "preemptive purchase right" provision allowing tenant right of first refusal if landlord received acceptable offer from "any person" referred only to third persons; court held that provision was not triggered by transfer between partners in family limited partnership that owned property and that parol evidence showed original owner's strong interest in keeping property in family; court further determined that transfer between partners had no effect on tenant's rights under lease or its preemptive rights against third-party purchasers).

VI. Carveouts for Portfolio or Bulk Sales

With respect to portfolio or bulk sales, the majority of courts hold that where an owner sells or attempts to sell property burdened by a right of first refusal as part of a larger package of properties, the right of first refusal is not defeated, but is also not activated in its traditional sense.

For example, in *First Nat'l Exchange Bank of Roanoke v. Roanoke Oil Co.*, 169 Va. 99, 113 (1937), the court stated, at 113:

> The record discloses that the manifest intention and import of clause eight of the lease [the right-of-first-refusal clause] was inserted for the protection of the lessee and its investment in the filling station. A sale of the property occupied by the oil company, free of the lease thereon, separately, or with other property, would seem in either event, under the language of the lease, to constitute "a sale of the said premises." It is clear that if the leased premises could be sold together with other property, discharged of the lease, without an opportunity being given to the lessee to purchase the whole property sold, or, at least, that portion occupied by it, the intention and purpose of the option would be completely destroyed. Certainly, any sale of the leased premises, free of the lease, affected both the premises and the lease.

See also Wilber Lime Products, Inc. v. Ahrndt, 268 Wis.2d 650, 656 (Wis. App. 2003) ("we agree with the circuit court's decision that the sale of the entire 180-acre farm to [a third party] triggered [the holder of the] right of first refusal to the twenty-five acres. Granting specific performance protects [the holder's] right of first refusal. [The holder] expected to be offered the opportunity to purchase the twenty-five acres in the event they were ever sold. The twenty-five acres were sold, albeit as part of a package deal. [The holder] should therefore have had the right to purchase the land); *Boyd & Mahoney v. Chevron, USA*, 419 Pa. Super. 24, 29-30 (1992) ("[A] right of first refusal as to the conveyance of a property cannot be defeated by including that property in a multi-property or multi-asset transaction . . . The appellant's argument that the right can be nullified simply by packaging the property for sale with another asset not so encumbered has no merit. Appellants' logic would deprive the holder of the right the benefit of his or her bargain"); *Stuart v. Stammen*, 590 N.W.2d 224, 228 (1999) (ruling that holder of right of first refusal could not be forced to purchase property in addition to that which was subject to such right); *Landa v. Century 21 Simmons & Co., Inc.*, 237 Va. 374 (1989) (holding that holder of right of first refusal cannot be compelled to purchase more than is subject to right of first refusal or else forfeit first-refusal right); *Raymond v. Steen*, 882 P.2d 852, 857 (Sup. Ct. Wyo. 1994) ("a right of first refusal is not triggered by an offer on a larger tract which includes the burdened property. Neither is a right of first refusal satisfied by an offer to the holder of the right to sell him a larger tract"); *Gyurkey v. Babler*, 103 Idaho 663, 668 (1982) (holding that even though vendor separately valued, as a part of total transaction, lot as to which plaintiff had right of first refusal, such lot could not be sold as part of larger parcel as long as lot was subject to such right of first refusal, because "the door would be opened to a myriad of unscrupulous endeavors designed to defeat preemptive rights of purchase by manipulation of lot prices within the terms of a larger sale"); *Whyhopen v. Via*, 404 So.2d 851, 853 (Fla. Dist. Ct. App. 1981) (landlord could not refuse to honor tenants' first refusal right on theory that tenants had not agreed to purchase entire parcel described in contract for sale); *Thomas & Son Transfer Line, Inc. v. Kenyon, Inc.*, 40 Colo. App. 150, 155 (1977), *aff'd* 586 P.2d 39 (Colo. 1978) (holding that owner of property cannot defeat right of refusal simply by selling optioned property with other properties that he may own; and stating that "To deny specific performance here would be to defeat the entire purpose of the right of refusal, the protection of the lessee"); *Guaclides v. Kruse*, 67 N.J. Super. 348, 359 (1961) ("We concur in the generally accepted view as to the optionee's right to an injunction to restrain a vitiating of its option by the inclusion, in the owner's prospective sale, of property in excess of that covered by the option. To allow the owner of the whole to by-pass the optionee merely by attaching additional land to the part under option would render nugatory a substantial right which the optionee had bargained for and obtained"); *Brito v. Belvedere Developers, LLC*, 2004 WL 877565 (R.I. Super., March 29, 2004) (unpublished opinion) ("Owners should not be permitted to attempt to sell their encumbered parcels to third parties by joining with other landowners, and then be able to deny the rightholder an opportunity to exercise his right by arguing that the encumbered parcel was part of a larger package"); *Sawyer v. Firestone*, 513 A.2d 36, 40 (R.I. 1986) ("a seller may not defeat a right of first refusal by selling the property subject to the right as part of a larger tract"); *Aden v. Estate of Hathaway*, 162 Colo. 311, 314 (1967) (ruling that holder of right of first refusal is entitled to injunctive relief, enjoining sale of burdened parcel, when owner decides to sell encumbered parcel as part of larger tract); *Chapman v. Mut. Life Ins. Co. of New York*, 800 P.2d 1147, 1151-52 (Wyo. 1990) (holding that while package deal did not trigger right of first refusal in its traditional sense, such that rightholder could purchase the property, rightholder was entitled to injunctive relief with respect to sale of burdened property; court stated that most often, courts will "return to the *status quo ante* and require a bona fide offer on the smaller tract before the right may be exercised or considered waived"); *USA Cable v. World Wrestling Fed'n Entertainment, Inc.*, 2000 Del. Ch. LEXIS 87 (Del. Ch., June 27, 2000), *aff'd* 766 A.2d 462 (Del. Super. 2000), at *44 ("New York courts construing right of first refusal clauses have uniformly held that a property owner cannot compel the holder of a right of first refusal to one property to match the terms of a package deal encompassing extraneous properties"); *New Atlantic Garden v. Atlantic Garden Realty Corp.*, N.Y. App. Div., 194 N.Y.S. 334 (1st Dep't 1922), *aff'd* 237 N.Y. 540 (1923) (holding that lessee of movie theater with right of first refusal cannot be forced to match terms of third party's offer to buy from lessor a larger parcel including the theater); *Myers v. Lovetinsky*, 189 N.W.2d 571, 575 (Iowa 1971) ("This is a case in which landlords sell the whole farm including the demised premises to purchasers without separately pricing the demised premises and the rest of the farm. The decisions recognize in this kind of case, apparently without exception, that the landlord breaches the tenant's preferential right [of first refusal] by so doing"); *Ollie v. Rainbolt*, 1983 OK 79, 669 P.2d 275, 280 (1983) ("Because the owner breached the tenant's preferential right by attempting to sell the leased premises as part of the larger tract, the tenant can seek injunctive relief to maintain the status quo until the end of the lease term, when his preferential right will have expired"); *Radio Webs, Inc. v. Tele-Media Corp.*, 249 Ga. 598, 601-02 (1982) (applying rule of law from lease cases holding that sale of parcel larger than the property for which a lessee held a right of first refusal was a breach of contract, and finding that rule applied to sale of a business; court ordered trial court to enter temporary injunction in favor of radio company and take whatever steps were necessary to protect its potential right to relief); *Maron v. Howard*, 258 Cal. App. 2d 473, 486-87 (1968) (holding that landlord cannot prevent exercise of right of first refusal to purchase property by accepting offer to purchase larger parcel including parcel subject to right); *Wilson v. Brown*, 5 Cal. 2d 425, 430 (Ca. 1936) (holding that where lessors conveyed mortgaged land, which included premises leased with option to purchase, trial court correctly ordered purchasers to convey leased premises to lessees free of encumbrances, with provision for retaining jurisdiction in case of default by purchasers); *Tarallo v. Norstar Bank*, 534 N.Y.S.2d 485, 487 (N.Y. App. Div. 1988) (lessees could not compel conveyance of entire parcel, as right of first refusal did not extend to entire parcel). *Cf. Rottier v. Walsh*, 230 Wis.2d 748 (1999) (unpublished opinion) at *3 (holding that unambiguous language of right of first refusal did not permit respondent to require rightholder to either purchase a portion of the parcel or abandon her right of first refusal on that portion, and remanded with instructions to issue declaratory relief and injunction; court stated that "The only reasonable meaning attributable to the document is that Walsh and Rottier intended the ROFR to apply to a sale of the entire property").

A minority of courts holds that the holder of the right of first refusal is entitled to specific performance on the burdened property alone (as opposed to injunctive relief), and that if the rightholder chooses not to exercise the right then the owner can proceed with the sale of the larger package. These courts generally have granted relief in the form of specific performance at a value set by the court or monetary damages, or where the parties have themselves assigned values to the different properties included in the package. *See, e.g.*, *Berry-Iverson Co. of N.D., Inc. v. Johnson*, 242 N.W.2d 126, 134 (N.D. 1976) (holding that attempted package sale activates right of first refusal, entitling rightholder to specific performance on burdened property alone); *Brenner v. Duncan*, 318 Mich. 1, 6 (1947) (ruling that with respect to attempted package sale including burdened property, "it is competent for the court to fix the option price, afford the optionee an opportunity to accept and thereupon specifically enforce the resulting contract"). In *Pantry Pride Enter., Inc. v. Stop & Shop Cos., Inc.*, 806 F.2d 1227, 1231-32 (C.A.4 (Va.),1986)., the court concluded that specific performance was the more appropriate remedy where the parties to the sale assigned separate valuations to the personalty and leasehold interests and, therefore, the problems commonly associated with awarding specific performance in such cases were not present. The court stated:

> In the typical case, a landowner leases a portion of his property to a lessee, who secures a right of first refusal. The landowner subsequently agrees to sell the leased portion and some adjacent property to a third party for a single price. When the lessee tries to purchase only the leased portion of the package, the lessor tries to force the lessee into accepting the package deal or allowing the sale. Most courts resolve this conflict by enjoining the sale of any property subject to the lessee's option. [Citations omitted.] Several practical problems arise in granting specific performance in these contiguous property cases. The first problem is one of valuation. If a court allows the lessee to buy only the leasehold portion, the court must allocate the single purchase price between the leased portion and the remainder of the lessor's property. Some courts are reluctant to undertake this process, which may require the court to determine the value of each acre offered for sale. [Citations omitted.] The second problem is that specific performance may be inequitable for three reasons. First, if the lessor sold the leased and nonleased portions together, he would probably receive a greater price than if he sold the properties separately. By forcing the lessor to sell only the leased portion, the court may be depriving the lessor of this premium. Second, the remaining property may be difficult to sell without the attached leased portion. Third, specific performance forces the lessor to separate his contiguous property merely because he leased a portion of it to the lessee. Because of these equitable considerations, most courts do not grant specific performance, but simply protect the lessee's option by enjoining the sale of the leased portion.

Id. at 1229-30.

Only one case appears to take the position that the rightholder's failure to enter into an agreement addressing the possibility of a package deal leaves the rightholder without a remedy. *See Cross-Spieker #23 v. Robert L. Helms Const. & Devel. Co.*, 731 P.2d 348, 350 (Nev. 1987) ("It is apparent from the terms of the right of first refusal, that the right applied only to offers to purchase Tract B. In this case, there was no such offer. Of course, we would not condone an attempt to evade [the holder of the right of first refusal's] contractual rights by engineering the sale of a larger parcel (citations omitted), but in this case there was no evidence of any wrongful intent. Rather, the record reflects a good faith decision by [the optionor] to sell the entire tract. Thus, [the holder of the right of first refusal's] contractual right was totally inapplicable by its own terms").

But if the language in the first-right-of-refusal clause or document is vague as to the terms and conditions under which the right may be exercised (including the amount of property covered), or specifically covers more than one parcel, the rightholder may be forced to match an offer for the entire package or else lose its right of first refusal. *See West Texas Transmission, L.P. v. Enron Corp.,* 907 F.2d 1554, 1564 (5th Cir. 1990) ("most courts have insisted that [holders of rights of first refusal] replicate a myriad of nonprice conditions, including . . . the purchase of a larger quantity of land"); *In re New Era Resorts*, LLC, 238 B.R. 381, 387 (Bankr. E.D. Tenn. 1999) (stating that "The parties did not define the word 'terms' in . . . the Lease Agreement to require the debtor to market the restaurant tract alone"; and ruling that because holder of right of first refusal rejected offer to purchase restaurant parcel together with other property and offered only to purchase restaurant parcel, right of first refusal lapsed and rightholder's offer constituted rejection and counter-offer, which debtor was free to and did reject). *But see USA Cable v. World Wrestling Fed'n Entertainment, Inc., supra*, 2000 Del. Ch. LEXIS 87, at *49 (distinguishing *West Texas Transmission, supra,* and stating that "*In re New Era Resorts [supra]* does not represent New York law on this subject"). *See also Crestview Builders, Inc. v. The Noggle Family Ltd. P'ship*, 352 Ill. App. 3d 1182, 1187-88 (2004) (holding that right of first refusal was not enforceable due to vagueness where it did not contain a price term and did not specifically state that price would be set by competing offer); *Uno Restaurants, Inc. v. Boston Kenmore Realty Corp.*, 441 Mass. 376, 387-89 (2004) (holding that bona fide offer to landlord existed where landlord received legitimate non-collusive offer to purchase property from third party, even if that offer was higher than market value; landlord did not violate covenant of good faith and fair dealing where lease did not require any particular action by landlord to protect tenant's right of first refusal); *Texaco Antilles Ltd. v. Creque*, 273 F. Supp. 2d 660, 663-665 (D.V.I. 2003) (holding that transfer of assets and liabilities by owner of property in connection with corporate restructuring did not trigger right of first refusal with respect to real property).

At least one court held that with respect to a package deal including the encumbered property, if the holder of the right of first refusal elected to exercise the right the rightholder was entitled to preemptive specific performance on the entire package. *See Capalongo v. Giles*, 425 N.Y.S.2d 225, 228 (N.Y. Spec. Term 1980) ("where an owner does have an offer from a third party to purchase a piece on which he has given a first refusal option, but on terms which specify inclusion of the piece in a larger parcel . . . he thereupon has a duty to offer the whole parcel to the option holder on the same terms"). But this decision was reversed on appeal, *sub nom Capalongo v. Desch*, 81 A.D.2d 689, 690 (N.Y. App. Div. 1981), *appeal dismissed*, 54 N.Y.2d 680 (1981), *aff'd*, 57 N.Y.2d 972 (1982), on the narrow issue of the adequacy of the consideration for the right of first refusal. The appellate court found that failure to give adequate consideration made the option agreement revocable. The owners of the property also contended that the option was in fact revoked by the rightholders, because the owners had advised the rightholders that they would not sell the triangular parcel (which was subject to the right of first refusal) separately from the remaining 123 acres. According to the owners, the rightholders stated that they were not interested in purchasing the larger tract. The owners also claimed that execution of the third-party contract for the entire 123 acres constituted a revocation of the option since such action was patently inconsistent with the terms of the option. The court agreed, finding that the option, which failed to recite either its duration or that it was irrevocable, was effectively revoked by the subsequent actions of the owners, and that the trial court erred in concluding that the option required the owners to give the rightholders a right of first refusal on the entire 123-acre tract. *See also Qualtronics Mfg. v. Levinson & Jaffe*, 1995 U.S. App. LEXIS 8529, at *3-4 (9th Cir., April 10, 1995) (affirming judgment in favor of lessee that it had not filed a groundless *lis pendens* notice against lessor's property where lease was silent as to whether right of first refusal extended to allow lessee to match an offer for entire business park; court found that district court properly concluded that tenant had "some basis" for its contention, and a "rational argument for its interpretation," that its right of first refusal extended to an offer to purchase other buildings along with its leasehold and, thus, lessee had some basis to record its *lis pendens* on the other buildings).

For an interesting decision on the issue of whether a proposed sale of property to a third party that consists of more than the property that is subject to a right of first refusal obligates the property owner to accept an offer from the holder of the right to purchase only the specific property, *see Thompson v. Herold*, 2004 Cal. App. Unpub. LEXIS 5888 (2d Appellate Div. June 22, 2004), reh'g denied, 2004 Cal. App. LEXIS 1200 (July 14, 2004). In this case a dentist leased the first floor of a two-story building. The lease gave the tenant the right to buy the building for its appraised value ($590,000) if the landlord chose to sell the "leased premises." If the tenant did not exercise the right, the lease would remain in effect and the landlord subsequently could offer it for sale to a third party, but the tenant would have a right of first refusal, to be exercised by giving written notice of acceptance within 45 days.

The landlord subsequently offered the building and the adjacent building it owned to the tenant for a net price of $1,165,000. The tenant counteroffered, proposing to purchase only the building he occupied for $590,000, and imposing additional conditions. This counteroffer was not accepted by the landlord by the date set forth in the counteroffer, and the landlord proceeded to place both properties on the market the day after the tenant's counteroffer expired. The landlord then accepted an offer of $1,135,000 for both buildings from a third party (although, "to obtain favorable financing," the third party issued a separate written offer for each property with $790,000 allocated to the building occupied by the tenant and $525,000 for the adjacent building). The landlord then offered the tenant the opportunity to match the $790,000 offer for the building occupied by the tenant. But the tenant insisted that it be allowed to purchase the building for $590,000.

The California appellate court ruled that the tenant's right to purchase the building it occupied for its appraised value was never triggered, so the owner was not obligated to accept the $590,000 offer from the tenant. The court reasoned that to trigger the tenant's right, the owner had to offer to sell the tenant only the building occupied by the tenant. Because the landlord offered two buildings to the tenant, the court ruled that the tenant's right was never triggered. According to the court, "[the tenant's] right has not yet arisen because [the landlord] listed the buildings as a package, rather than as individual properties. This failed to trigger [the tenant's] preemptive right to purchase a single building, as required under the . . . lease . . . [the landlord] ha[s] failed to present [the tenant] with an offer that specifies the purchase price of [the building occupied by the tenant] as a single building." *Id*. at *13-14.

Interestingly, the court prefaced its holding by engaging in a discussion of the differences between an option and a "preemptive purchase right." With respect to options the court stated that, "At the outset, we must distinguish between an option contract and a preemptive purchase right because the parties use the term interchangeably. The important distinction is that only an option contract may be specifically enforced. A preemptive right is not subject to specific performance because it is not a contract (citation omitted). An irrevocable option is a contract made for consideration, to keep an offer open for a prescribed period (internal quotations and citation omitted). It is a unilateral contract and is binding on both parties (citation omitted). If the seller refuses to perform, the contract may become the subject of a suit for specific performance (citation omitted). The decision to exercise an option rests with the prospective purchaser." *Id*. at *9-10.

With respect to first rights of refusal (or, as the court describes them, "preemptive purchase rights"), the court stated that, "By contrast, a preemptive purchase right is dependent upon the owner's decision to sell his property (citation omitted). A preemptive right gives the grantee the first opportunity to purchase property if the owner chooses to sell (citation omitted) (emphasis in text). If the owner elects not to sell, the buyer cannot compel a sale (citation omitted). For this reason, a preemptive purchase right is not a contract and may not be specifically enforced (citation omitted)." *Id*. at *10-11.

Attached hereto as **Appendix A** is a sample form of first-right-of-refusal clause for insertion in a lease, with numerous "carveouts" for items not intended to be granted to the holder of the right. *See generally* Sara Church Dinkler and Morgan R. Smock, *Toss That Form Book: How to Draft an Effective Right of First Refusal*, 16 NO. 4 ACCA Docket 50 (July/August 1998), at 59; Harris Ominsky, *Real Estate Options: Using Them and Losing Them (Part 1)*, 15 NO. 6 PRAC. REAL EST. LAW. 55 (November, 1999), at 65; Bernard Daskal, *Rights of First Refusal and the Package Deal*, 22 FORDHAM URB. L.J. 461 (Winter 1995); Thomas J. Goger, *Landlord and tenant: what amounts to "sale" of property for purposes of provision giving tenant right of first refusal if landlord desires to sell*, 70 A.L.R. 3d 203 (originally published in 1976); Jean E. Maess, *Option to purchase real property as affected by optionor's receipt of offer for, or sale of, larger tract which includes the optioned parcel*, 34 A.L.R. 4TH 1217 (Originally published in 1984).

VII. Conclusion

As evidenced by the cases and statutory law discussed in this article, it is imperative for the parties to contractual option rights, rights of first refusal, and related rights to carefully and comprehensively draft the documents describing such rights so that they clearly express the intention of the parties with respect to the scope of the rights granted (especially the types of transfers that are covered and are not covered), in order to avoid unintended and undesirable consequences. As noted in the article, it is especially important to address specifically any desired "carveouts" from coverage -- *e.g.*, condemnation or sale to a governmental entity; portfolio or package sales that include other properties along with the property subject to the option or related right; sales or transfers of equity interests in entities owning the property (including stock transfers and transfers between tenants in common) that would effectively constitute an a sale of the property; foreclosure or deed in lieu of foreclosure; gifts and donations; certain indirect transfers of the properties or the equity interest(s) therein; sales or transfers by individuals to family members or into estate-planning trusts or LLCs or transfers of partnership or LLC interests in family-owned partnerships or LLCs to individual family members; and sales involving exchanges of real estate or exchange of the property or other types of exchanges for non-cash consideration. [Note: in the case of tax-free exchanges under § 1031 of the Internal Revenue Code, or other non-cash consideration (such as unique personal property) for the sale, transfer, or exchange of the property covered by the option or related right, what if nothing is said in the documentation to cover such a situation? From a drafting standpoint, it probably would be wise to either exclude any such transaction from the option or related right altogether, or else provide a valuation mechanism, perhaps enforceable by arbitration if the parties are unable to agree upon the value of the consideration within a specified period of time, whereby the optionee would have the ability to pay the consideration, as so determined, in cash]. Each of these carveouts must be specifically and comprehensively drafted to address the clear intentions of the parties. As this article clearly illustrates, clauses regarding options to purchase and related rights contained in leases and other legal documents are very complex and require a great deal of attention from counsel, with respect to both the business terms and the legal aspects and consequences.

APPENDIX A

RIGHT OF FIRST REFUSAL (LEASE PROVISION)

a. **Right of First Refusal.** Provided that Tenant:

(i) Is not in default under this Lease,

(ii) Has not assigned this lease or sublet all or part of the Premises, or

(iii) Is not holding over in the Premises,

if Landlord enters into a contract to sell its entire fee interest in the Premises (and only the Premises) (a "Sale"), Tenant shall have a one-time right of first refusal to purchase of the entire Premises ("Refusal Right"). In the event of a Sale, Landlord shall notify Tenant in writing of the prospective Sale of the Premises ("Landlord's Notice"). Landlord's Notice shall include the elements of the business deal of such prospective Sale (the "Elements"), and a contract of sale executed by Landlord containing the material terms of the Sale (the "Contract of Sale") for Tenant's signature.

b. **Tenant's Exercise of Right.** In order to exercise the Refusal Right, Tenant shall:

(i) Accept the terms of the Sale as set out in the Contract of Sale by notifying Landlord, in writing, sent by registered or certified mail, return receipt requested, of its intent to so accept, postmarked within five (5) business days after receipt of Landlord's Notice; and

(ii) Execute and return to Landlord the Contract of Sale within fifteen (15) days after receipt of same from Landlord.

c. **Proof of Financing.** If Tenant shall timely exercise the Refusal Right, Tenant shall, within five (5) days following its execution of the Contract of Sale, provide Landlord with evidence of a non-contingent financing commitment or other evidence acceptable to Landlord, in Landlord's sole and absolute discretion, of Tenant's ability to close on or before the closing date set forth in the Contract of Sale. If Tenant has not shown Landlord such evidence within the five (5) day period, Landlord shall have no obligation to sell the Premises to Tenant and Tenant's rights under this Clause shall forever be null and void.

d. **Closing.** Following Landlord's receipt of satisfactory evidence from Tenant of Tenant's ability to close pursuant to the terms of the Contract of Sale, Landlord and Tenant shall proceed to close the sale of the Premises no later than the closing date set forth in the Contract of Sale.

e. **Lapse of Refusal Right.** If Tenant shall fail to timely perform any of its obligations as set forth herein, or if Tenant shall opt not to exercise the Refusal Right, the Refusal Right shall lapse and Landlord shall be free to sell the Premises pursuant to the Elements or any subsequent agreement for the transfer of the Premises.

f. **No Assignment of Right.** The Refusal Right is personal to Tenant and may not be assigned by Tenant in connection with and assignment of this Lease or otherwise. The Refusal Right may not be exercised by anyone other than Tenant. Any attempted assignment of the Refusal Right shall be of no effect and the Refusal Right shall become forever null and void as of the date of the purported assignment.

g. **Events Not Triggering Refusal Right.** ***Anything contained herein to the contrary notwithstanding, in the event of any of the following, the Refusal Right shall be deemed not to have arisen and of no force and effect:***

- ***(i)*** ***The sale of the Premises to an Affiliate (as defined in Clause _____ hereof) of Landlord or to a government entity;***
- ***(ii)*** ***The sale of the Premises in connection with a sale of all or substantially all of Landlord's assets or shares (or interests);***
- ***(iii)*** ***Landlord's shares becoming or continuing to be traded on the New York, or Over-the-Counter stock exchange or market or any similar exchange or market;***
- ***(iv)*** ***The entering into of any management agreement or any similar agreement which transfers control of the Premises by Landlord;***
- ***(v)*** ***The entering into by Landlord of any ground lease, mortgage, or trust deed upon all or any portion of the Premises, any advances made thereunder and all renewals, modifications, consolidations, replacements, extensions, and re-financings thereof; or***
- ***(vi)*** ***The entering into a contract by Landlord for the sale of more than one property wherein the Premises is one of such properties.***
- ***(vii)*** ***Sale or transfer of the Premises by foreclose, deed in lieu of foreclosure, or bankruptcy sale.***
- ***(viii)*** ***Any like-kind exchange with respect to the Premises under § 1031 of the Internal Revenue Code, or any other sale or transfer of the Premises for non-cash consideration. [Note: In lieu of the foregoing, a method of valuation for any non-cash consideration could be inserted, perhaps with an arbitration requirement if the parties are unable to agree on the cash value of such consideration within a certain period of time].***
- ***(viii)*** ***Any gift or donation of the Premises.***

h. **Subordination.** The Refusal Right shall be subject and subordinate to any mortgage now or hereafter placed upon the Premises or any portion of the [*Building/Center*], and to any renewals, modifications, consolidations, replacements, extensions, and re-financings thereof. Tenant agrees to execute and deliver whatever instruments may be requested by any Lender for such purposes. If Tenant fails to do so within ten (10) days after demand in writing, Tenant does hereby make, constitute, and irrevocably appoint Landlord as its attorney-in-fact (which shall be deemed to be coupled with an interest) and in its name and place to execute and deliver such instruments.