

Pitfalls of the Right of First Refusal
By
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Although permitted by law and contained in many condominium declarations in Illinois, the right of first refusal is not a well-understood or effective tool. The secondary mortgage market will tolerate but does not favor the right of first refusal. In this article, we will evaluate the right of first refusal and its usefulness.

To begin with, the right of first refusal (sometimes termed as right of first option or similar) is often misunderstood. The right of first refusal is not a right to simply approve or reject a prospective purchaser or renter of a unit. Rather, the right of first refusal typically gives the Association the opportunity “to step into the shoes” of the prospective purchaser or renter, and to assume that purchase contract or lease as the purchaser or renter, as the case may be. Thus, the Board of Directors (Board of Managers) must essentially adopt and fulfill the contract or lease on the same terms and conditions as originally agreed to between the unit owner and the purchaser/tenant; for example, if Unit Owner A contracted to sell his/her unit for “X” dollars, then the Board/Association will purchase that unit for “X” dollars (similarly, if Unit Owner A had agreed to rent the unit for “Y” dollars per month, then the Board/Association will rent that unit for that rent). Importantly, in order to implement the right of first refusal, the Illinois Condominium Property Act requires approval by at least 2/3 of all the unit owners (by percentage of ownership interest in the common elements); and it is permissible for the condominium declaration to require an even higher supermajority. Finally, the timeframe for the Board/Association to review the terms and conditions of the transaction and related information and to obtain the requisite approval of the unit owners is typically a mere 30 days.

Given its cumbersome nature and challenging requirements (a 2/3 vote in a large association would be extremely difficult to obtain), what purpose does the right of first refusal serve? Often, the justification or value of the right of first refusal is to preserve unit values; or make a (quick) profit; or obtain necessary space for Association purposes; or prevent undesirable persons from purchasing or renting a unit in the condominium.

As for maintaining unit values, the exercise of the right of first refusal will not bolster or elevate unit values. Since the Board/Association would be purchasing (or renting) the unit on the same terms and conditions as originally proposed by the owner of the unit, there would be no such effect. Indeed, the public data will still reflect the “too low” sale price, whether the unit is purchased by the Board/Association or the originally proposed buyer. Of course, if the unit is being sold at fair market price, the Board/Association would have no interest in exercising the right of first refusal.

As for making a profit, the Board/Association is sometimes motivated to seize the opportunity of acquiring an under-market priced unit and “flipping” it to extract the equity, possibly to bolster reserve funds or for some other purpose. It may be questionable for a Board/Association to implement such a strategy, but it is certainly legally allowable. Of course, the Board/Association must be able to persuade the unit owners that its analysis of the situation is sound.

As for the ability to obtain necessary space for Association purposes (for example, additional office or social space), that motive may be appropriate but again, the unit owners must also perceive that need to the same degree as the Board.

As for preventing “undesirables” from moving into the condominium, it is absolutely clear that the right of first refusal cannot be used to engage in illegal

discrimination and any attempt to do so will be subject to severe penalties. Moreover, even if the motive is really not illegal, there may be such allegations (typically by the prospective purchaser or tenant who would be displeased by the exercise of the right of first refusal). Beyond that potential hassle, how “undesirable” must the prospective purchaser/renter be so as to obtain the approval of exercising the right of first refusal by the unit owners? It seems that most unit owners would prefer not to spend the money to buy or rent a unit, unless the prospective purchaser/tenant had bubonic plague (and only if the unit was on their floor).

Finally, the right of first refusal often extends for a period of 30 days starting with the Board being notified of the prospective sale or lease. This situation has given rise to arguments over when the time period begins to run, especially when the information and documents dribble in piecemeal; demands (and even threats) by sellers and purchasers for a hurry up, last minute waiver; extractions of a fee (usually hefty and arguably questionable by the Association or its managing agent to shortcut the typical 30 day period); and possibly petty vindictiveness where a Board will “sit on” the waiver just teach thoughtless real estate agents a lesson.

I know of at least one situation where the right of first refusal was included in the original condominium declaration in favor of an adjacent unit/unit owner on the penthouse level of a highrise condominium, as opposed to the Board/Association. Apart from such an arrangement, can the Board/Association assign its right of first refusal to another party (such as another unit owner or even an outside party) for that party to exercise for his/her/its own benefit? Perhaps with the Board/Association being paid by that party for the assignment? Unless the right of first refusal provisions expressly allows for an assignment, the answer is uncertain. If the assignment is legally

permissible, then that assignee would arguably not be subject to the unit owners' approval requirement. If any such assignment is attempted, the Board/Association should have broad protections in any assignment agreement.

The net value of the right of first refusal is probably minimal at best. It is misunderstood, cumbersome and often gives rise to meaningless (but potentially expensive) sub-disputes. Nonetheless, if it works for you, I guess that's the final answer.

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