

# ROFR MADNESS – HOLDOVER TENANT LOSES!

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## **How to Avoid Finding Yourself in Similar Litigation**



Rights of first refusal are common in commercial leases – both purchase option rights and expansion rights. What’s uncommon is a tenant attempting to exercise such a right during a holdover tenancy following the expiration of the lease term.

In a recent California case, the court, based upon the facts before it, determined that rights of first refusal expire when the term of the lease expires. In this case, the tenant, Smyth, operated a business in North Hollywood leasing space from Berman. Smyth had leased the property since the mid-1990s through a series of leases and owned the residence next door. The most recent lease contained a right of first refusal to purchase the property. The lease term expired in December, 2015. Based on the terms of the lease, Smyth became a month-to-month holdover tenant when he didn’t vacate the premises.

In June 2016, a third party submitted a written offer to buy the property from Berman. Upon learning of the potential sale, Smyth made an offer to purchase the property based upon his first right of refusal, which Berman rejected. Smyth then filed a lawsuit against Berman and others

for specific performance, breach of contract and fraud. The trial court rejected his case, and Smyth then filed an appeal.

The main issue before the appellate court was whether a right of first refusal is an “essential” term of a lease that is presumed to carry forward into a holdover tenancy. In analyzing whether Smyth continued to have a right of first refusal to purchase the property, the Court examined the landlord/tenant relationship during a holdover period. The Court concluded that the “relationship” of the parties change upon the expiration of the lease term. During the lease term the landlord/tenant relationship is based on “privity of contract,” but when the term expires, the relationship changes by operation of law and is based on “privity of estate.” While the parties are still bound by the lease, only those lease terms that are deemed to be “essential” survive the expiration of the lease. This holding is consistent with a majority of the states. Essential terms include the amount of rent to be paid and the time for payment of rent. The Court also based its decision on public policy concerns favoring the stability of commercial tenancies. Holdover tenancies exist to ensure stability because tenants are permitted to remain in possession without disruption to the business, typically on a month-to-month basis. As a landlord can terminate a holdover tenancy, generally upon 30-days’ notice, such termination would clearly nullify any potential lease rights. If rights of first refusal carry through to the holdover, landlords would be incentivized to terminate the holdover tenancy as soon as possible, “a result at odds with the stability of commercial leases.”

### **Caveats to Landlords and Tenants:**

1. Any right of first refusal language must be clear and well-drafted. In this case, it was a handwritten ROFR added by the tenant and initialed by the landlord, and provided little or no details as to how it would operate.
2. State clearly whether option rights (and other critical rights) expire upon the expiration of the lease term.
3. Be sure that your holdover clause, which is usually ignored in drafting as “boilerplate”, is well-drafted in view of this opinion and its implications, which extend beyond ROFRs. The terms of the Lease that are intended to apply during the relationship known as “privity of estate” after the lease term

expires and the holdover begins are largely undefined by case law, so, if you are a Landlord, make sure ROFRs and other critical tenant rights (such as options to extend) do not survive lease term expiration, so you are not surprised!