71926-5 71926-5

No. 71926-2-1

**IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I**

RSD AAP LLC,

Plaintiff/Appellant,

vs.

ALYESKA OCEAN, INC.; JEFF HENDRICKS AND JANE DOE HENDRICKS, individually and as a marital community,

Defendants/Respondents.

APPELLANT'S OPENING BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Other Authorities

Rules

I. INTRODUCTION

Appellant RSD AAP LLC ("RSD") requests that this Court reverse the trial court's grant of summary judgment in favor of Respondents Alyeska Ocean, Inc. and its owner, Jeff Hendricks (collectively, "Mr. Hendricks"). RSD brought this lawsuit to enforce its rights under common law and under a specific provision of the governing Partnership Agreement for the Aurora/Auriga General Partnership ("AAGP"), in which it and Mr. Hendricks are Partners. Section 7.3 of that Partnership Agreement expressly gave all the Partners, including RSD, a "Right of First Refusal" with regard to the sale of a Partner's interest. Mr. Hendricks wrongfully deprived RSD of that right by purchasing for himself the interest of a dying Partner named Mark O'Brien, through a series of actions that violated his fiduciary duties as a Partner, as managing partner, and as the holder of Power of Attorney for all of the AAGP Partners, including RSD.

In granting summary judgment on RSD's claims for breach of fiduciary duty and breach of contract, the trial court made three fundamental mistakes.

<u>First</u>, the trial court held that RSD's contract claim fails because as a matter of law Mr. Hendricks technically complied with a different provision of the Partnership Agreement—Section 7.1.1, entitled "Transfer Prohibited," by getting the <u>prior</u>, <u>written</u> consent of two-thirds of the non-selling Partners. This holding was erroneous because:

- Whether Mr. O'Brien properly secured consent under Section 7.1.1 was clearly a disputed issue of fact. The trial court's ruling was premised on a finding that Mr. O'Brien did not execute the contract to sell his interest until May 31, 2012. However, the contract itself said that "the Parties have caused this Agreement to be effective and executed the date first written above," which date is "May 24, 2012."

- The trial court erred in holding, without discussion, that Mr. O'Brien could not have been "bound" by the agreement to sell his interest, and did not "accept" Mr. Hendricks' offer, until May 31, 2012. The issues of the date on which Mr. O'Brien "accepted" Mr. Hendricks' offer, and when he was "bound" by their agreement, turned on facts that were disputed; those disputes should not have been resolved on summary judgment.

- The trial court found that Mr. Hendricks' declaration, standing alone, established that he had secured prior written consent from two-thirds of the other Partners, when that declaration says nothing about whether the consent was made in writing.

Second, the trial court erred in holding that, as a matter of law, Mr. Hendricks could not have breached his fiduciary duties to RSD, because he complied with Section 7.1.1. That holding was error, even if Mr. Hendricks complied with Section 7.1.1, because:

- The trial court overlooked the fact that Mr. Hendricks, as Partner, managing partner of the AAGP, and holder of Power of Attorney, owed "the highest" fiduciary duties to RSD—duties that went well beyond the duties set forth in the Partnership Agreement.

- The trial court failed to address RSD's allegation and evidence that the opportunity to purchase the O'Brien Interest was a "partnership opportunity." Whether it was a partnership opportunity was a factual question, to be determined by the trier of fact, not on summary judgment. If it was a partnership opportunity, Mr. Hendricks breached his fiduciary duties by obtaining it for himself, even if he obtained two-thirds "consent."

- Even if the opportunity to purchase the O'Brien Interest was not a "partnership opportunity," the trial court failed to address RSD's evidence that Mr. Hendricks acted in bad faith, and with a lack of loyalty and candor, in the process of obtaining "consent" of two-thirds of the non-selling Partners.

Third, the trial court erred in holding, as a matter of law, that the Partnership Agreement allows a Partner to evade the Right of First Refusal requirement of Section 7.3 by obtaining the consent of two-thirds of the non-selling Partners under Section 7.1.1. The textual and extrinsic evidence established that the parties intended the Right of First Refusal to be an unqualified right of each and every Partner, not a "right" that any Partner could lose by the vote of some sub-set of the other Partners.

This Court should reverse the summary judgment and remand the case for trial on the disputed material issues.

II. ASSIGNMENTS OF ERROR

A. The Trial Court Erred in Reaching the Factual Finding That Mr. Hendricks Complied with Article VII of the Partnership Agreement.

1. A Trier of Fact Could Readily Conclude That Mr. Hendricks Did Not Comply With Section 7.1.1 of the Partnership Agreement.

The trial court found that there was no dispute that Mr. Hendricks complied with Section 7.1.1 of the Partnership Agreement by securing the written consent of two-thirds of the Partners (excluding Mr. O'Brien), prior to Mr. O'Brien "encumbering" his interest by agreeing to sell it to Mr. Hendricks. However, the evidence raised a triable issue whether: (1) the two-thirds consent came before or after Mr. O'Brien encumbered his interest; and (2) Mr. Hendricks <u>ever</u> secured <u>written</u> consent, as required by Section 7.1.1.

2. A Trier of Fact Could Conclude That RSD Obtained a Right of First Refusal Under Section 7.3 <u>Before</u> Mr. Hendricks Secured Consent Under Section 7.1.1.

Upon concluding (erroneously) that Mr. Hendricks complied with Section 7.1.1, the trial court found that RSD did not have a right of first refusal under Section 7.3. However, a reasonable trier of fact could conclude that RSD's right of first refusal under Section 7.3 with respect to the O'Brien transaction matured before May 31, 2012, the date on which Mr. Hendricks claims to have secured consent under Section 7.1.1. A right of first refusal under Section 7.3 matures before a selling Partner "agrees" to sell his interest. The evidence is substantial, even overwhelming, that Mr. O'Brien "agreed" to sell his interest to Mr. Hendricks on or before May 15, 2012 or, at the latest, May 24, 2012.

B. The Trial Court Erred in Granting Summary Judgment on RSD's Breach of Fiduciary Duty Claim.

The trial court erred in granting summary judgment on RSD's claims for breach of fiduciary duty. There was no dispute that Mr. Hendricks—as a general Partner, managing partner and holder of Power of Attorney—owed not only fiduciary duties, but the "highest" fiduciary duties, to RSD. These duties are <u>not</u> discharged simply by virtue of technical compliance with the terms of the Partnership Agreement. A reasonable trier of fact could conclude that Mr. Hendricks breached those heightened fiduciary duties by: (1) usurping for himself an opportunity that rightfully belonged either to AAGP or to all the Partners; (2) failing to provide timely disclosure to the Partners of a number of material matters relating to the O'Brien transaction, including Mr. O'Brien's imminent death; the negotiation and terms of the proposed transaction; and the Partner's rights under the Partnership Agreement; and (3) engaging in a pattern of conduct in dealing with the other Partners which was designed to frustrate their free exercise of their rights under the Agreement.

C. RSD Had a Right of First Refusal Notwithstanding Any "Compliance" With Section 7.1.1.

The trial court held that the Partnership Agreement allowed the sale of the O'Brien Interest to proceed "under either Section 7.1 or 7.3." Verbatim Report of Proceedings ("VR") at 30. However, the language of the agreement and relevant extrinsic evidence supports the opposite conclusion: that the parties intended Section 7.3 to have priority over Section 7.1; that the right of first refusal exists any time a Partner wishes to sell his interest; and that no Partner can be deprived of his right by the consent or vote of two-thirds of the non-selling Partners.

III. STATEMENT OF THE CASE

A. The Aurora/Auriga General Partnership

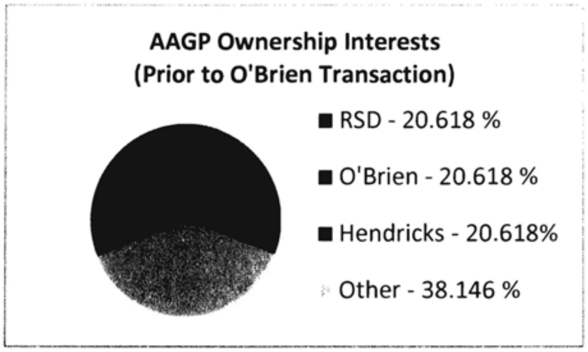
In 1986 Mr. Hendricks began work on a venture to acquire and convert two vessels for commercial fishing. CP 51. To raise capital for the venture, he prepared an offering of partnership interests in a general partnership (AAGP) that would own and operate the vessels. Id. In 1987 he prepared an Offering Memorandum to present to and attract potential investors (partners). Id. The Offering Memorandum highlighted the important right conferred by Section 7.3 to each and every Partner:

> the Partnership Agreement includes a right of first refusal pursuant to which a Partner seeking to sell his interest in the Partnership must provide a written notification of such transfer and its terms. The other Partners have 30 days in which they can agree to purchase the interests on those terms and conditions.

CP 230 (emphasis added). The Offering Memorandum made no mention of the ability of a selling Partner to deny the right of first refusal to the non-selling Partners, or to any one of them, by obtaining "consent" of two-thirds of the non-selling Partners or otherwise. Id.

RSD is a general partner in AAGP. CP 178. Prior to the transfer of Partnership Interests that RSD challenges in this lawsuit, RSD owned 20.618% of the outstanding interests of the Partnership. Id. RSD is a successor-in-interest to Robert Resoff, Inc., one of the two largest original investors and partners in the Partnership. CP 178-179.

Respondent Alyeska Ocean, Inc. is also general partner in AAGP, and is controlled by Respondent Jeff Hendricks, its sole shareholder. CP 50-51. Prior to its recent purported acquisition of the O'Brien Interest (20.618% of the Partnership), Mr. Hendricks owned 20.618% of the Partnership Interests. CP 54. The ownership of AAGP, prior to that transaction, is represented in the following chart:



As a result of his purported acquisition of the O'Brien Interest, Mr. Hendricks now claims to own approximately 41% of the Partnership Interests.[1]

In addition to being a general partner, Mr. Hendricks has been the Manager (effectively the managing partner) since the formation of AAGP. CP 51. The Partnership Agreement states that the Manager (Mr. Hendricks) "shall have all powers of a Manager hereunder and as a managing general partner under law . . ." CP 69 (emphasis added). Under the Partnership Agreement Mr. Hendricks was required to act in "good faith" with respect to his management of AAGP. CP 69. In addition, he required, as a condition to entry into the AAGP, that every Partner grant him Power of Attorney with respect to the affairs of the partnership. CP 181.

B. Relevant Provisions of the Partnership Agreement

In this appeal, RSD challenges the trial court's rulings with respect to RSD's claim for breach of fiduciary duty, and its claim for breach of the

[1] In 2012, the Partnership was valued at roughly $69 million, or $690,000 per percentage "share." CP 179.

Partnership Agreement. With regard to the latter, the following provisions of the Partnership Agreement are relevant to this Court's analysis.

1. Section 7.1 – Transfer Prohibited

Section 7.1.1, entitled "Transfer Prohibited," provides that

> [n]o Partner may, without the prior written consent of the Partners holding at least a two-thirds interest in the Partnership (excluding the transferring Partner's interest), . . . sell, lease, transfer . . . all or any part of his interest in the Partnership . . . except as provided in this Article VII and Section 8.2.

CP 70. Section 7.1 further provides that any transfers of Partnership Interests must meet certain conditions, including that transfers can only be to U.S. citizens, that any transferee must agree to be bound by the Partnership Agreement, and that a transfer cannot be made to a minor, among others. CP 70-71.

2. Section 7.2 – "Permitted Transfers"

Section 7.2 affirmatively allows a Partner to transfer his or her "entire interest" in the Partnership to a corporation that he or she owns, without complying with the Right of First Refusal provisions of Section 7.3. CP 71.

3. Section 7.3 – "Right of First Refusal"

Section 7.3 provides that, if a Partner receives an offer to purchase its shares and desires to accept it, or if a Partner decides to sell or contract to sell its interest, he or she

> shall, prior to accepting such offer or entering into an unconditional agreement for the sale, afford to the other Partners (the "Option Partners") written notification of such intentions . . .

CP 71-72. Section 7.3.2 provides that, within thirty days of receipt of such notice, the Option Partners may "elect to purchase the Partnership Interest of the Selling Partner upon the same terms and conditions" outlined in the notice. CP 72. If no Option Partners elect to make such a purchase, the Selling Partner may then proceed with the proposed sale. Id.

Section 7.3.5 provides that the right of first refusal "shall be extended to all of the Partners wishing to exercise [the right of first refusal] without preference . . .," and that all Option Partners desiring to exercise the option will split the Selling Partner's interests pro rata. CP 72-73. In other words, every Partner had the right to preserve and/or enhance his or her ownership position in the Partnership—vis-a-vis the other Partners or potential new Partners—by participating in any proposed sale of Partnership Interests to an extent at least equal to his or her current ownership position.

C. Shortly After the Partnership Is Formed, Mr. Hendricks Recognizes That the Contemplated Sale of a Partner's Interest Triggers the Right of First Refusal.

Just three months after AAGP commenced operations, the Partnership, and its Manager Mr. Hendricks, had an opportunity to apply the Agreement's provisions to a sale of a Partnership Interest. In May 1988, one of the Partners, Biernes RSW Trawlers, decided it wanted to sell its 5% interest. CP 204. On May 14, 1988, Mr. Hendricks (acting as Manager) sent a letter to the Partners explaining this, and indicating that two of the vessels' crew members (Tod Hendricks and Matt Lieske) were interested in joining the Partnership by buying the 5% Biernes share (2.5%

each). Id. Mr. Hendricks carefully explained, however, that the current Partners had a right of first refusal with regard to the Biernes interest:

> I want all the partners to be immediately aware of this development and that we have an option to purchase the share ourselves according to our partnership agreement. If any partner has any comments, especially about the potential sale to Tod and Matt, please call me as soon as possible to avoid any misunderstandings or disappointments.

Id. (emphasis added). All Partners consented to the transfer.

D. In 2012, Mr. Hendricks Acquires the Partnership Interests of the Dying Mark O'Brien, at a Bargain Price, While Denying the Remaining Partners Their Rights of First Refusal.

1. Upon Learning That Mr. O'Brien Is in the Final Stage of Lung Cancer, Mr. Hendricks Offers to Buy His Partnership Interest, Without Informing the Other Partners of Mr. O'Brien's Condition or the Offer.

The following events are reflected in a timeline attached as Appendix A. Mr. Hendricks approached Mark O'Brien on April 24, 2012 to offer to purchase Mr. O'Brien's roughly 20% interest in the Partnership. CP 55. Mr. Hendricks claims that he learned for the first time during that call that Mr. O'Brien was suffering from terminal cancer and had only a few weeks to live. Id. Rather than inform the other partners of Mr. O'Brien's terminal illness and his desire to sell his Partnership Interest, as he had done with regard to the sale of the Biernes interest, Mr. Hendricks proceeded in secret to negotiate solely on his own behalf and to settle on price and other terms with Mr. O'Brien. CP 55.

2. Mr. Hendricks Had in Mind the Partnership's Option to Purchase at Death When Negotiating with Mr. O'Brien, But Did Not Want to Make Mr. O'Brien Aware of It.

On April 27, 2012, Mr. Hendricks wrote to his accountant, expressing concern that Mr. O'Brien's Partnership Interest could fetch a much higher price if the O'Brien estate sold it after Mr. O'Brien's (imminent) death, because under the Partnership Agreement it would be based on the value of the assets of the Partnership rather than the deeply discounted "estimate" that Mr. Hendricks provided to Mr. O'Brien. CP 213. He expressed concern that, if Mr. O'Brien's advisors realized this differential in value, they may "start second guessing" Mr. Hendricks' offer, which "may be a deal killer" and may "collapse any agreement" between Mr. Hendricks and Mr. O'Brien. Id. He warned that it would best to proceed in a manner that would not "prompt" Mr. O'Brien's advisors to make that sort of inquiry, into what he called the "after death option." Id.

That "after death option" would have provided Mr. O'Brien's heirs with the opportunity to secure a higher price for the O'Brien Interest. More importantly for purposes of this lawsuit, it also would have allowed all of the remaining Partners to share the substantial benefit of acquiring that interest and of maintaining their respective ownership positions in the Partnership.

3. Mr. Hendricks Secures a Deal With Mr. O'Brien, and Only Then Informs the Other Partners About Mr. O'Brien's Impending Death and the "Agreement" He Had Already Made to Purchase the O'Brien Interest.

Having apparently succeeded in keeping Mr. O'Brien in the dark about the potential value of his Partnership Interest, Mr. Hendricks secured an agreement with Mr. O'Brien to purchase that interest for $4 million. CP 55, 117. It was only after reaching that agreement that Mr. Hendricks wrote to the other Partners, informing them in a May 15, 2012 letter that he had already made a deal with Mr. O'Brien to purchase his shares:

> It is with great sadness to inform you that our partner, Mark O'Brien, is in the final stage of lung cancer that has also spread to his lymph nodes...Mark and I have agreed that after his death, my corporation, Alyeska Ocean, Inc., would purchase Mark's corporate interest in the partnership.

CP 117 (emphasis added). Having informed the other Partners that the transaction was already a done deal, Mr. Hendricks asked that each Partner sign a "Consent and Waiver," expressly waiving their rights of first refusal under section 7.3. Id. Mr. Hendricks provided no information regarding the terms of the proposed purchase and sale, saying only: "Feel free to call if you have questions about the agreement or Mark's condition." Id.

By May 24, 2012—more than a week before Mr. Hendricks purports to have obtained the consent of two-thirds of the non-selling Partners—Mr. Hendricks and Mr. O'Brien had reduced their agreement to writing, setting forth the specific terms and conditions they had agreed to for the purchase (the "Option Agreement"). CP 121-123. The Option Agreement gave Mr. Hendricks the irrevocable option to purchase the O'Brien Interest, on Mr. O'Brien's death, at the price of $4 million, or $200,000 per percentage share. Id. The agreement expressly states that it was "executed the date first written above," which date is written as "May 24, 2012." CP 123. The minutes of a board of directors meeting for O'Brien Maritime (the entity that held the O'Brien Interest) confirms that "on May 24, 2012, O'Brien entered into an agreement with [Mr. Hendricks] . . . granting [Mr. Hendricks] an irrevocable option to purchase O'Brien's 20.618% partnership interest . . ." CP 144.

F. Mr. Hendricks Refuses to Provide RSD with Information Regarding the O'Brien Transaction, Unless and Until RSD Waives its Rights With Respect to That Transaction.

On June 5, 2012, RSD's President, George Steers, first received a copy of the May 15th letter from Mr. Hendricks regarding the sale. CP 180. Mr. Steers explained to Mr. Hendricks' attorney that RSD's managers would need information about the transaction in order to consider whether to exercise their right of first refusal. Id. Mr. Hendricks' attorney responded several days later by explaining that Mr. Hendricks did not feel he needed RSD's consent, because he had already secured the consent of two-thirds of the non-selling Partners. Id. In a subsequent letter sent to RSD on June 25, 2012, Mr. Hendricks explained that he would not provide RSD with information about the O'Brien transaction unless RSD first consented to it:

> If you are agreeable to the transaction between Mark and I, you are welcome to any of its details.

CP 211 (emphasis added). It was not until July 10, 2012—one day after Mr. O'Brien died—that Mr. Hendricks disclosed the material terms of the O'Brien-Hendricks Transfer to RSD. CP 180, 139.

G. RSD Exercises Its Right of First Refusal

On July 13, 2012, just three days after learning the price and other terms of the O'Brien transaction, RSD notified Mr. Hendricks in writing that, pursuant to the terms of Section 7.3, it would review the transaction details and elect, within 30 days, whether or not to participate in the sale. CP 215-216. On August 8, 2012, in compliance with Section 7.3.1, RSD wrote to Mr. Hendricks, informing him that RSD had elected to participate in the purchase of the O'Brien Interest and was ready, willing and able to complete the transaction immediately. CP 57, 147-148. Mr. Hendricks refused to recognize RSD's rights under the Partnership Agreement.

H. Proceedings in the Trial Court

RSD filed this lawsuit on February 13, 2013, seeking declaratory and equitable relief to enforce its right to participate in the purchase of the O'Brien Interest. CP 291-299. Mr. Hendricks moved for summary judgment on March 10, 2014. CP 1-21. The trial court held the hearing on the motion on April 10, 2014. It ruled in favor of Mr. Hendricks and granted summary judgment on all of RSD's claims. CP 277-281. RSD timely filed its notice of appeal on May 9, 2014. CP 282.

IV. ARGUMENT

Summary judgment should be granted only if the pleadings, affidavits and other evidence on the record demonstrate the absence of any genuine issue of material fact, and that the moving party is entitled to judgment as a matter of law. CR 56(c). "When determining whether an issue of material fact exists, the court construes all facts and inferences in favor of the nonmoving party." Michael v. Mosquera-Lacy, 165 Wn.2d 595, 601 (2009). A genuine issue of material fact exists, and summary judgment is improper, where "reasonable minds could reach different conclusions." Id.

This Court reviews the trial court's grant of summary judgment de novo. Verdon v. AIG Life Ins. Co., 118 Wn. App. 449, 452 (2003). As explained below, the trial court erred in granting summary judgment in favor of Mr. Hendricks.

A. Even if the Trial Court Interpreted the Partnership Agreement Correctly, It Erred in Ruling as a Matter of Law That RSD Did Not Have a Right of First Refusal.

Section 7.1.1 provides that "no Partner may, without the prior written consent of the Partners holding at least a two-thirds interest in the partnership . . . sell, lease, transfer, assign, give, pledge, hypothecate or otherwise encumber" his Partnership Interest except as provided in Article VII and Section 8.2. CP 70. The trial court granted summary judgment based on its conclusions that (1) Mr. Hendricks complied with Section 7.1.1's "consent" clause; and (2) compliance with Section 7.1.1 obviated the rights of first refusal under Section 7.3. The trial court erred in reaching both of those conclusions on summary judgment.

1. A Trier of Fact Could Conclude That Mr. Hendricks Failed to Obtain Written Consent Prior to Mr. O'Brien Encumbering His Partnership Interest.

In finding that Mr. Hendricks properly secured consent under Section 7.1.1, the trial court held that: (1) Mr. O'Brien did not execute the Option Agreement until May 31, 2012; (2) the O'Brien Interest was not "encumbered" until that date; and (3) by May 31, 2012, Mr. Hendricks had secured the "written consent" of two-thirds of the Partners. In reaching each of these conclusions, the trial court overlooked critical issues of disputed fact.

a. The Documentary Evidence Indicates That Mr. O'Brien Signed the Option Agreement on May 24, 2012.

The Option Agreement, which is no doubt an "encumbrance" on the O'Brien Interest, is clearly dated "May 24, 2014." CP 121. The minutes of the Board of Directors for O'Brien Maritime, discussing the transaction, state that the Option Agreement was entered "on May 24, 2014." CP 144. More importantly, the Option Agreement plainly states, above the signatures of Mr. O'Brien and Mr. Hendricks, that it was "executed the date first written above," which date is written as "May 24, 2012." CP 123, 121.

Remarkably, the trial court ruled that what the contract document itself said about its execution date did not even raise an issue of fact regarding its execution date. The trial court instead chose to credit only

Mr. Hendricks' self-serving declaration, in which he states that although the agreement was "executed effective May 24," Mr. O'Brien "did not sign" the agreement until May 31. CP 56. In choosing to credit Mr. Hendricks testimony, when it conflicted with the documentary evidence, the trial court violated the most basic rule governing summary judgment: all inferences are to be drawn, and all factual disputes resolved, in favor of the <u>non</u>-moving party. <u>Mosquera-Lacy</u>, 165 Wn.2d at 601.

b. The Trial Court Erred in Holding, as a Matter of Law, That Mr. O'Brien Was Not "Bound" to Abide by the Option Agreement Until He Executed the Contract Document.

The trial court held that, despite the fact that the Option Agreement was dated May 24, 2012, Mr. O'Brien could not have been bound to grant the option, and thereby encumber his interest, until he executed the contract document. VR at 31-32. Even assuming, <u>arguendo</u>, that Mr. O'Brien did not execute the document until May 31, 2012, the trial court's conclusion was erroneous.

The question whether parties intend to be bound to the terms of an agreement, <u>prior</u> *to* the formal execution of contract documents, must be answered by reference to the <u>evidence</u> of such intent.

> In determining whether informal writings such as letters are sufficient to establish a contract even though the parties contemplate signing a more formal written agreement, Washington courts consider whether (1) the subject matter has been agreed upon, (2) the terms are all stated in the informal writings, and (3) the parties intended a binding agreement prior to the time of the signing and delivery of a formal contract.

Morris v. Maks, 69 Wn. App. 865, 869 (1993). Accordingly, the question whether execution was a condition precedent to the creation of an obligation must turn on examination of the agreement itself, the writing that preceded the formal agreement, the communications between the parties and other relevant extrinsic evidence. See McKenna v. Capital Resource Partners IV, L.P., 650 S.E.2d 580, 583 (Ga. App. 2007) (in cases where the parties disagree regarding the necessity of formal execution of contract documents, "the circumstances surrounding the making of the contract, such as correspondence and discussions, are relevant in deciding if there was a mutual assent to an agreement").

"Where such extrinsic evidence exists and is disputed, the question of whether a party has assented to the contract is generally a matter for the jury." Id. Here, the trial court appeared to rely on nothing more than its own, incorrect, view that a party can never be bound before formally executing a contract. The trial court cited neither legal authority for this proposition, nor evidence indicating that this was the parties' intent.

In fact, there was no evidence that the parties intended a formal execution to be a condition precedent to the enforceability of the "agreement" they reached on or before May 15, 2012. The only relevant evidence was to the contrary:

- The fact that the parties undisputedly made the Option Agreement "effective" May 24, 2012, is strong evidence that they believed that their agreement existed as of that date, even if the document had not yet been signed. There is no evidence on the record offering any other explanation for the fact that the Option Agreement is dated May 24, 2012 or that the execution was expressly made "as of" May 24, 2012.

- Mr. Hendricks himself confirmed that by May 15, 2012 he had made a specific offer to Mr. O'Brien ($4 million plus $500,000 for upcoming Partnership distributions), and that Mr. O'Brien had "agreed" to sell on those terms. To state the obvious, this is strong evidence that the parties' negotiations had matured to the point of "agreement" by that date.

The evidence that the parties had agreed to the terms of the Option Agreement on or before May 24, 2012 is strong and uncontroverted, so much so that the trial court could have summarily adjudicated the issue in favor of RSD. At a minimum, the trial court plainly erred in adjudicating it in favor of Mr. Hendricks.

c. The Trial Court Mis-Read Mr. Hendricks' Declaration.

The trial court found that Mr. Hendricks' declaration, standing alone, established that he had received "written consent of two thirds of the partners," as required by Section 7.1.1. VR at 31-32 (emphasis added). However, that declaration says nothing whatsoever about the consent being in writing. Mr. Hendricks merely declares that, by May 31, 2012, "I had the consent of 2/3 of the partners, excluding the transferring partner." CP 56 (emphasis added). Here, the trial court apparently mis-read the text of the declaration, and based on that manifestly erroneous reading "found" a material fact that had not been established anywhere in the record.[2]

[2] It is unlikely that the lack of record evidence of written consent is simply an oversight by Mr. Hendricks. It would have been a simple matter for Mr. Hendricks to attach the written consents, if in fact he had secured them. The only consent that Mr. Hendricks did

2. A Trier of Fact Could Readily Conclude That Mr. O'Brien "Accepted" Mr. Hendricks Offer <u>Before</u> Mr. Hendricks Obtained Written Consent Under Section 7.1.

While the "trigger" under Section 7.1.1 was the "encumbrance" of Mr. O'Brien's Interest, the trigger under Section 7.3 was Mr. O'Brien's "acceptance" of Mr. Hendricks' offer to purchase his shares. CP 71-72 ("<u>prior to</u>" a Selling Partner "accepting" an offer to purchase his or her interest, the non-selling Partners have the right to review the transaction and participate in the purchase) (emphasis added). The trial court appeared to conclude that Section 7.3 was never triggered, because Mr. O'Brien did not <u>execute</u> the Option Agreement until May 31, 2012, by which time Mr. Hendricks had obtained two-thirds written consent under Section 7.1.1.

Even if the trial court were correct, that consent under Section 7.1.1 can ever be a substitute for providing the right of first refusal under Section 7.3, it was incorrect in finding that, in this case, the consent was secured "prior to" Mr. O'Brien "accepting" Mr. Hendricks' offer to purchase the O'Brien Interest.

a. The Documentary Evidence Indicates That Mr. O'Brien Executed the Option Agreement on May 24, 2012.

As discussed in section 1.a. above, whether Mr. O'Brien executed the Option Agreement on or prior to May 31, 2012 was a disputed issue of

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submit was from one partner, Matt Lieske, who holds a 2.5% interest. But that consent was provided <u>after</u> May 31, 2012. CP 126 (on June 4, 2012, Mr. Lieske tells Mr. Hendricks that he had forgotten about the request for consent until Friday, June 1, 2012, but had signed and sent it to Mr. Hendricks on that date).

fact. The trial court erred in resolving it in favor of Mr. Hendricks on summary judgment.

b. The Evidence Indicates That Mr. O'Brien "Accepted" Mr. Hendricks' Offer Well Before May 31, 2012, Even If He Did Not Sign Until That Date.

There is no legal or evidentiary support for the trial court's apparent conclusion that, as a matter of law, Mr. O'Brien did not "accept" Mr. Hendricks' offer until he executed the Option Agreement on May 31, 2012. The question of what constitutes "acceptance" of an offer "is normally a question of fact," which "may be determined as a matter of law where reasonable minds could reach but one conclusion." Keystone Land & Dev. Co. v. Xerox Corp., 152 Wn.2d 171, 178 n. 10 (2004) (emphasis added); see also Citibank South Dakota NA v. Ryan, 160 Wn. App. 286, 290 (2011) (a court may resolve questions of mutual assent as a matter of law only "where reasonable minds could not differ" regarding the inferences to be drawn from the evidence).

Here, there was ample—indeed compelling—evidence in the record that Mr. O'Brien "accepted" Mr. Hendricks' offer prior to May 31, 2012:

- In his own declaration Mr. Hendricks testified that, on May 10, 2012 he "offered to pay $4 million plus $500,00" for the O'Brien Interest, and that, by May 15, 2012, "Mark and I had agreed" to the purchase and sale of the O'Brien Interest. CP 55 (emphasis added). A May 10 "offer," followed by a

May 15 "agreement" is strong evidence that Mr. O'Brien had accepted Mr. Hendricks offer on or before May 15.[3]

- The Option Agreement states that it is "entered into as of May 24, 2012," and specifically states that it was "executed" by both parties on May 24, 2012. CP 121-123. Even assuming that Mr. O'Brien did not sign until May 31, 2012, the fact that the parties made the agreement effective May 24, 2012, and specifically made their execution "as of" May 24, 2102, is strong evidence that Mr. O'Brien had "accepted" Mr. Hendricks' offer as of May 24, 2012.

- Minutes of the Board of Directors of O'Brien Maritime, the entity that held the O'Brien Interest, state that "on May 24, 2012, O'Brien <u>entered into an agreement with Alyeska Ocean, Inc.</u>" to purchase the O'Brien Interest after Mr. O'Brien's death. CP 144 (emphasis added).

As discussed above, the trial court provided no legal or factual support for its apparent conclusion that "acceptance" of an offer necessarily requires that the accepting party formally execute the final contract document.

If Mr. O'Brien had in fact "accepted" Mr. Hendricks' offer by May 15 or May 24, RSD's rights under Section 7.3—to receive notice of the proposed transaction, the terms of same, and 30 days to evaluate whether to exercise the right of first refusal—would have been triggered "prior to" those dates. Summary judgment was improper.[4]

c. The Trial Court Mis-Read Mr. Hendricks' Declaration.

As explained above, the trial court made a clear error in finding that Mr. Hendricks' declaration, standing alone, established that he had

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[3] Black's Law Dictionary defines "accept" as, <u>inter alia</u>, "[t]he offeree's notification or expression to the offeror that he or she agrees to be bound by the terms of the offeror's proposal." Mr. Hendricks' testimony—that by May 15, 2012 Mr. O'Brien "agreed" to his offer—is tantamount to an admission that, by that date, Mr. O'Brien had "accepted" that offer, thus triggering Section 7.3.1.

[4] There is nothing in the Partnership Agreement that suggests that a Partner's right of first refusal—once triggered—can be divested by obtaining the consent of <u>other</u> Partners.

received "written consent of two thirds of the partners," as required by Section 7.1.1. VR at 31-32 (emphasis added). If Mr. Hendricks did not secure written consent before May 31, 2012, the O'Brien Transaction did not satisfy the plain requirements of Section 7.1.1. In such case, RSD would have a right of first refusal, even if the trial court were correct that Section 7.1.1 offered an "alternative" to Section 7.3.

B. Even if Mr. O'Brien Complied With the Technical Requirements of the Partnership Agreement, a Trier of Fact Could Reasonably Conclude That He Breached His Fiduciary Duties in the Process of Acquiring the O'Brien Interest.

The trial court appeared to reason that, because (in its view) the O'Brien Transaction technically complied with Section 7.1.1 of the Partnership Agreement, Mr. Hendricks ipso facto discharged his fiduciary duties to his fellow Partners with regard to that transaction.[5] This was error. Even assuming arguendo that the transaction complied with Section 7.1.1, Mr. Hendricks' duties to his fellow Partners extended far beyond the technical requirements of that provision, and a trier of fact could reasonably conclude that he breached those duties.[6]

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[5] After concluding that Mr. Hendricks complied with Section 7.1.1, the trial court simply stated that "[u]nder these circumstances, I don't think that Mr. Hendricks breached his fiduciary duties owed to the partners or the partnership, and that claim has to fail as well." VR 32. The trial court did not discuss any of the evidence that RSD presented regarding the manner in which Mr. Hendricks went about "complying" with Section 7.1.1, nor did it acknowledge that Mr. Hendricks had duties that went beyond the duty to comply with the express terms of the Partnership Agreement.

[6] Of course, if the Court agrees that there was a triable issue regarding Mr. Hendricks' compliance with Article VII—even under the trial court's own interpretation of that provision—then its sole basis for granting summary judgment on the fiduciary duty claim disappears as well.

1. Mr. Hendricks Owed RSD Fiduciary Duties That Extended Beyond the Specific Terms of the Partnership Agreement.

General partners owe one another the duty of loyalty and a duty to exercise their rights and discharge their responsibilities under the partnership agreement "consistently with the obligation of good faith and fair dealing." RCW 25.05.165(2) & (4). Specifically, they have a duty to disclose to their fellow partners, in a timely fashion, <u>any</u> information relating to the affairs of the partnership.

> Each member of the partnership is required to fully disclose all known information that is significant and material to the affairs or property of the partnership. <u>Partners are confidential agents of each other and have a right to know all that the other partner knows and are required to fully disclose all material facts that relate to partnership affairs</u>. A material nondisclosed fact in the contest of a general partner's fiduciary duty is one that might be expected to have induced action or forbearance by the other partners. What is material depends on the specific context and the partners' knowledge and information.

<u>Bishop of Victoria Corp. Sole v. Corp. Bus. Park, LLC</u>, 138 Wn. App. 443, 458 (2007) (emphasis added and quotations omitted).

But Mr. Hendricks owed an even higher duty than that owed between and among co-partners, because he held a unique and special position in the Partnership, and had a special relationship of trust with each of the other Partners. This is true for two reasons.

First, Mr. Hendricks was AAGP's first and only Manager, holding "all powers . . . as a managing general partner . . ." CP 69. He held that position on the date AAGP was formed and the twenty-six years of its existence. As Manager, he received substantial compensation from the Partnership, including 2% of the fishing vessels' gross revenue and a $5,000 per month "administration fee." CP 83. He had an explicit duty under the Partnership Agreement to act in "good faith" in managing the Partnership, including in exercising his duty to "provide all notices required or advisable" pursuant to the Partnership Agreement. CP 69, 237. And, as the de facto managing partner, he owed "the highest possible fiduciary duty" to the other Partners. Triple Five of Minnesota, Inc. v. Simon, 404 F.3d 1088, 1097 (8th Cir. 2005) ("a managing partner owes the highest possible fiduciary duty to his partners"). Indeed, as managing partner, Mr. Hendricks had "the burden of dispelling all doubts concerning the discharge of his duties." Bovy v. Graham, Cohen & Wampold, 17 Wn. App. 567, 571 (1977) (observing that managing partners "occup[y] a higher fiduciary position" than general partners) (emphasis added).

Second, the special, heightened relationship of trust between Mr. Hendricks and every other Partner is evidenced by the fact that he held a Power of Attorney as to each Partner, including RSD. Keene v. Bd. of Accountancy, 77 Wn. App. 849, 858 (1995) (holder of Power of Attorney has "the fiduciary duty of loyalty that accompanies that relationship . . . [i]n the time-honored words of Justice Cardozo, the fiduciary relationship requires '[n]ot honesty alone, but the punctilio of an honor the most sensitive....'"). That power extended generally to all of the Partnership's business, and specifically included matters relating to "the Partnership Agreement" and changes of ownership among the Partners. CP 244-245.

2. Mr. Hendricks Breached the Duty of Loyalty by Appropriating a Partnership Opportunity.

In opposing Mr. Hendricks' summary judgment motion, RSD explained that the opportunity to purchase the O'Brien Interest was a "partnership opportunity," and as such, that Mr. Hendricks was required to present the opportunity to all of the Partners rather than withhold the information so that he could secure it for his own sole benefit. See RCW 25.05.165 (2) (duty of loyalty includes duty to refrain from appropriating "partnership opportunity"). The trial court granted summary judgment in favor of Mr. Hendricks without any discussion or finding on this critical issue.

The issue whether a particular transaction presented a partnership opportunity "depends upon the facts and circumstances of each particular case." Wagner v. Foote, 128 Wn.2d 408, 413, 908 P.2d 884 (1996), citing Equity Corp. v. Milton, 221 A.2d 494, 497 (S. Ct. Del. 1966) ("The determination of this question is always one of fact to be determined from the objective facts and surrounding circumstances."). The particular "facts and circumstances" of this case clearly establish that the opportunity to purchase the O'Brien Interest was a partnership opportunity. At a minimum they raise a factual dispute that foreclosed summary judgment.

Under Article VIII of the Partnership Agreement, the Partnership had the opportunity, upon Mr. O'Brien's passing, to purchase the O'Brien

Interest for the benefit of the Partnership as a whole. CP 74; see Equity Corp. v. Milton, 221 A.2d 494, 497 (S. Ct. Del. 1966) (test for corporate opportunity is whether the opportunity "fit into an established corporate policy which the acquisition of the opportunity would forward").[7] Knowing that Mr. O'Brien was in the final stage of lung cancer, and knowing that the Partnership would have the opportunity to purchase the O'Brien Interest upon Mr. O'Brien's imminent passing, Mr. Hendricks deliberately preempted that opportunity by negotiating his own competing, personal "option" with Mr. O'Brien, while failing to inform the other Partners of Mr. O'Brien's critical condition until after the agreement was made.

Assuming, for the sake of argument, that the Partnership or the Partners were capable of ceding a partnership opportunity to the managing partner and their attorney-in-fact, such an action would require timely, informed consent after a full disclosure of all material facts. Here, Mr. Hendricks provided no material facts—not even the price of the purchase—when he sought the consent of the Partners. And at the same time he asked for their "prior" consent, he represented to them that he and Mr. O'Brien had already "agreed" to the transaction. CP 117. A trier of fact could readily conclude that, in obtaining the consents, Mr. Hendricks failed to live up to the "highest fiduciary duty" that the law imposed on him. Simon, 404 F.3d at 1097 (managing partner breached fiduciary duty

[7] See Noble v. Lubrin, 114 Wn. App. 812, 819 (2003) (adopting Equity Corp. as test for "corporate opportunity").

by negotiating to secure for himself a partnership opportunity, and waiting until the deal was nearly done before disclosing the opportunity to his co-partner).

Finally, Mr. Hendricks counted his own shares towards the two-thirds "consent," despite the fact that he was the most interested party to the proposed transaction. While Section 7.1.1 explicitly requires that the shares of the selling Partner be excluded from the "consent" vote, the intent behind that requirement was clearly to ensure fairness to the Partnership and to the Partners severally, by removing any interested Partners from the vote. Where the proposed purchaser of a selling Partner's interest is also a Partner, the spirit of Section 7.1.1 plainly requires that the purchaser's shares likewise be excluded. See Blake Rohrbacher, et al., Finding a Safe Harbor: Clarifying the Limited Application of Section 144, Delaware J. Corp. Law, Vol. 33, No. 3 (2008).

3. Mr. Hendricks Breached His Fiduciary Duties Even if the Chance to Acquire the O'Brien Interest Were Not a "Partnership Opportunity."

In acquiring the O'Brien Interest for his sole benefit, Mr. Hendricks engaged in acts of concealment, overreaching, and misrepresentation. His conduct is the antithesis of the candor, good faith and "honor" that the law required of him.

a. Departing From His Own Past Practice, Mr. Hendricks Failed to Disclose Mr. O'Brien's Impending Death or the Negotiations to Purchase the O'Brien Interest.

As discussed above, in 1988 Mr. Hendricks learned that Biernes RSW Trawlers, an original Partner with a 5% interest, wished to sell that interest in the Partnership. As Manager, Mr. Hendricks faithfully discharged his duties by orchestrating the communications and documentation related to that sale. See supra Section III.C.

Specifically, once he learned that Biernes wanted to sell and that two non-Partners wanted to buy the interest, Mr. Hendricks took great care to "immediately" notify the Partners of the proposed transaction, and of the Partners' "option to purchase the share ourselves according to our partnership agreement." Id. He ensured that the proposed sale did not go forward until the Partners had reviewed the proposed terms, considered their rights under Section 7.3.1, and made an informed decision to expressly waive them. Id.

There is a stark and telling contrast between Mr. Hendricks' handling of the Biernes transfer—a transfer involving a modest Partnership Interest and potential buyers other than himself—and his conduct related to the opportunity to acquire the much larger O'Brien Interest, for himself. As explained above, upon learning of Mr. O'Brien's late-stage terminal cancer, Mr. Hendricks knew that, under the provisions of the Partnership relating to the death of a Partner, the Partnership as a whole would very soon have the chance to acquire that interest, to the benefit of each and every Partner. CP 74. He also knew that, if Mr. O'Brien desired to sell his interest before his death, <u>any or all</u> of the remaining Partners might have been interested in acquiring it on a <u>pro</u> <u>rata</u> basis, under Section 7.3 of the Partnership Agreement. CP 71-72.

But, where in 1988 Mr. Hendricks had "immediately" informed the Partners of the proposed Biernes transfer and dutifully explained their opportunity to participate in it, here he chose instead to keep the critical information to himself, to allow him the time and space to pursue the opportunity solely for his own benefit. A trier of fact could conclude that this was a breach of Mr. Hendricks' heightened fiduciary duty to the other Partners.

b. Mr. Hendricks Exploited What He Believed to be Mr. O'Brien's Ignorance Regarding His Rights Under the Partnership Agreement.

While he was failing to disclose to the Partnership Mr. O'Brien's terminal illness or the negotiations between himself and Mr. O'Brien, Mr. Hendricks was working to ensure that Mr. O'Brien did not become aware of information that might lead him to elect to proceed under the provisions governing a deceased Partner's interest, or demand a higher price for his shares. In an email to his personal accountant,

- Mr. Hendricks acknowledged that Mr. O'Brien would be much less likely to accept Mr. Hendricks' $4 million offer if Mr. O'Brien's advisors discovered that the O'Brien Interest might fetch a much higher price, under Article VIII of the Partnership Agreement, <u>after</u> Mr. O'Brien's imminent death. CP 213.
- Mr. Hendricks proposed that they proceed with negotiations in a manner that would not prompt Mr. O'Brien's advisors to

"second-guess" Mr. Hendricks' $4 million offer or engage in "due diligence" regarding Mr. O'Brien's rights under Article VIII. Id.

- Mr. Hendricks expressed concern that, if Mr. O'Brien understood what his Partnership Interest might sell for after his death, it would be a "deal killer" and "may collapse any agreement" between Mr. Hendricks and Mr. O'Brien. Id.

c. When Mr. Hendricks Finally Disclosed the Transaction to the Partners, He Presented it as a *Fait Accompli*.

Even under his own (incorrect) reading of the Partnership Agreement, Mr. Hendricks knew that his purchase of the O'Brien Interest could not proceed unless he secured the "prior" express written consent of Partners holding two-thirds of the Partnership Interests. However, when Mr. Hendricks sent letters to the Partners requesting their "consent," and informing them for the first time of Mr. O'Brien's condition and desire to sell his interest, he stated that the deal between himself and Mr. O'Brien was already "agreed":

> Mark and I have agreed that after his death, my corporation, Alyeska Ocean, Inc., would purchase Mark's corporate interest in the partnership.

CP 117 (emphasis added).

d. Mr. Hendricks Engaged in Bad Faith Tactics to Deny RSD's Simple Request for Information Regarding the Transaction.

In response to RSD's request for information regarding the terms of the proposed transaction, Mr. Hendricks insisted that RSD was not entitled to any of that information because a sufficient number of Partners had "consented" to the transaction already. CP 180. Shortly thereafter, Mr. Hendricks stated that he would provide the information, but only if RSD first gave its consent to the transaction going forward. CP 134 ("If you are agreeable to the transaction between Mark and I, you are welcome to any of its details.") (emphasis added). Mr. Hendricks finally provided the requested information (a copy of the Option Agreement) to RSD, but not until after Mr. O'Brien died. CP 139. Mr. Hendricks' demand that RSD consent to the transaction as a condition precedent to obtaining any information about it, and his effort to delay disclosure until after Mr. O'Brien's death, exhibit bad faith and a lack of candor.

C. The Trial Court's Interpretation of Article VII Was Erroneous.

The trial court erred in concluding, based on the text of the agreement and extrinsic evidence, that the parties intended Section 7.1 to offer an "alternative" to Section 7.3 for a Partner wishing to sell his or her interest. RSD contends that the relevant text and context clearly support its interpretation, that Section 7.3 confers rights of first refusal notwithstanding any consent obtained under Section 7.1. At a minimum, a trier of fact could reasonably conclude that the extrinsic evidence, taken together with the text and structure of the contract, raised a disputed issue of fact with regard to the meaning of Article VII. This court reviews the trial court's interpretation of the contract de novo. Cambridge Townhomes, LLC v. Pac. Star Roofing, Inc., 166 Wn.2d 475, 487 (2009).

1. At the Time They Entered into the Partnership Agreement, the Partners Understood and Intended That the Rights of First Refusal Would Apply to Any

Attempted Sale by a Partner and Be Available to all Partners Without Preference.

Before embarking on a detailed analysis of the terms of the Partnership Agreement and the rules for proper interpretation of contracts, we encourage the Court to keep in mind the underlying reality that drafting complex business agreements is a difficult task. The fact that the parties to this case have each been able to construct arguments based on grammar and syntax for why the Partnership Agreement should be read one way or the other says more about that difficulty than it does about what the parties intended when they entered into the Agreement in 1988.

That intention was clearly and unambiguously expressed in the Offering Memorandum which described and explained the key terms of the Partnership Agreement to the potential investors, including Appellant.

> [T]he Partnership Agreement includes a right of first refusal pursuant to which a Partner seeking to sell his interest in the Partnership <u>must</u> provide a written notification of such transfer and its terms. The other Partners have 30 days in which they can agree to purchase the interests on those terms and conditions.

CP 230 (emphasis added).[8] There were no exceptions. A Partner willing to sell to anyone, at any price, <u>must</u> first offer it to all of the other Partners, each of whom had a <u>right</u>, independent of the others to participate in the proposed transaction. That is what was represented to the potential

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[8] The Offering Memorandum is relevant and admissible extrinsic evidence of the parties' intent. <u>Brown v. Scott Paper Worldwide Co.</u>, 143 Wn.2d 349, 364 (2001) ("As an aid in ascertaining the intent of contracting parties, a court may admit extrinsic evidence relating to <u>the entire set of circumstances under which the contract was formed.</u>") (emphasis added); <u>Berg v. Hudesman</u>, 115 Wn.2d 657, 669 (1990) (relevant and cognizable items of extrinsic evidence include "preliminary negotiations and statements made therein").

investors, including RSD, and is now being denied by the very Partner who made the representations in the first place. There was no suggestion that the right could be taken away from any one Partner by the vote or consent of the others, or that Mr. Hendricks even thought such a possibility existed.

"Rights of First Refusal" are just that: "Rights". The rights belong to the holders of the rights and are economically valuable and important. While they can serve a number of purposes in different types of agreements, where, as here, they are granted to the initial investors in a closely held partnership, they assure each investor that he or she will be able to participate in any and all future sales of Partnership interests which they deem to be on advantageous economic terms.[9] The sale by O'Brien Maritime, Inc. was on terms which RSD believed to be economically advantageous, the very situation the Agreement's Right of First Refusal addressed. The trial court's ruling frustrated that basic intention and allowed one Partner to seize an opportunity intended for all.

2. If Mr. Hendricks Intended That Section 7.1.1 Should Trump Section 7.3, He Was Required to Disclose That Intent.

At the time the parties entered into the contract, they had a common understanding that (i) Section 7.3 gave each partner a right of first refusal in the event of the sale of a Partnership Interest and (ii) each

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[9] See Robert Wise, First Refusal Rights Under Texas Law, 62 Baylor L. Rev. 433, 445 (2010) (in the context of partnerships, the right of first refusal is included "to assure compatible management, maintain control . . . and to provide the current owners with an opportunity to increase their ownership interest if the stock, interest or property becomes available at an attractive price").

Partner wishing to sell its Partnership Interest was required to offer it to the others in accordance with Section 7.3. Mr. Hendricks now says that that is not what he thinks 7.3 means. He now claims that a Partner wishing to sell is not required to follow 7.3, that it is merely an optional path.

By interpreting the Partnership Agreement in accordance with Mr. Hendricks' present view of the meaning of 7.3, the trial court ruling violated the fundamental rule of contract interpretation, set forth in the Restatement of Contracts 2d Section 201, entitled "Whose Meaning Prevails":

> Where the parties have attached different meanings to a promise or agreement or term thereof, it is interpreted in accordance with the meaning attached by [RSD] if at the time the agreement was made
>
> . . . (b) [RSD] had no reason to know of any different meaning attached by [Mr. Hendricks], and [Mr. Hendricks] had reason to know the meaning attached by [RSD].

Mr. Hendricks knew or had reason to know that, at the time the Agreement was made, RSD attached the meaning to Section 7.3 which was set out in the Offering Memorandum, namely that each Partner had a Right of First Refusal and that any Partner wishing to sell his Partnership Interest had to offer it first to all of the Partners. There is nothing in the record to suggest that, at the time the Agreement was made, RSD knew or had any reason to know that Mr. Hendricks attached any different meaning.

3. The Text and Structure of the Partnership Agreement Support RSD's Interpretation.

That the parties intended each Partner to have a right to participate in the O'Brien sale which could not be taken away by a vote of other Partners is evident from the language of the Agreement itself.

a. Section 7.3 Trumps All of Section 7.1.1.

Mr. Hendricks relies upon the provisions of Section 7.1.1 of the Partnership Agreement, entitled "Transfers Prohibited," to justify depriving RSD of its rights under Section 7.3. But Section 7.3 begins with the phrase "Notwithstanding the provisions of 7.1.1…" (that means all of 7.1.1, not just part of it).[10] The term "Notwithstanding" is one of several "trumping" terms, used by draftsmen to reconcile two provisions of an agreement which are in conflict or which deal with overlapping subject matter. City of Seattle v. Ballsmider, 71 Wn. App. 159, 162 (1993) (the definition of 'notwithstanding' is "'in spite of,' which in turn is defined as 'in defiance of, regardless of . . .'"), quoting Webster's New World Dictionary 974, 1374 (2d ed. 1976).

Here, Section 7.3 deals with sales specifically and Section 7.1.1 deals with transfers generally, of which a sale is but one example.

> The careful draftsperson will always note these possible inconsistencies and employ trumping provisions to indicate which provision overrides the other. Otherwise, confusion and potential disputes are the result.

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[10] See "Drafting Matters", Adams, Kenneth A., New York Law Journal (July 5, 2002) ("In this sentence, notwithstanding means "in spite of" or "despite" and serves to indicate that while the subject matter of Section [7.1.1] overlaps with that of the quoted sentence, the quoted sentence should be read and interpreted as if Section [7.1.1] did not exist.") (relevant Section references modified to reflect the Partnership Agreement).

Working with Contracts - What Law School Doesn't Teach You, Charles M. Fox, Practicing Law Institute, 2002; see id., Sec 5:3:2 (discussing the use of "notwithstanding" as a trumping provision). The draftsperson of the Partnership Agreement clearly used the phrase "Notwithstanding the provisions of Section 7.1.1," to make clear that Section 7.3 "trumps" and has priority over all of Section 7.1.1.

b. Section 7.3.1 Expressly Requires a Partner Who Decides to Sell to Provide Notice to the Other Partners and to Proceed Under the Remaining Provisions of Section 7.3.

Subsection 7.3.1. reads in relevant part as follows:

> In the event a Partner…(i) receives a[n] …offer to purchase his interest in the Partnership and the Selling Partner desires to accept it,… he shall prior to accepting such offer… afford to the other Partners (the "Option Partners") written notification of such intentions . . .

CP 71-72 (emphasis added). The notice must contain details of the material terms and conditions of the proposed transaction, including the purchase price. Id.

Once the notice is received, each Partner has 30 days in which to exercise its right of first refusal by electing to purchase the interest. Id. The rights of first refusal are triggered by the Selling Partner's receipt of an offer and the desire to accept it. The process to implement the exercise of those rights is set in motion. Nothing in Section 7.3.1 or anywhere else in Section 7.3 suggests that the process can be aborted and the rights of the

Partners to participate in the sale terminated by consent of less than all of the Partners.[11]

c. **The Use of the Word "May" in the Introductory Language of Section 7.3 Simply Means That a Partner Is Not Required to Sell its Partnership Interest.**

The complete introductory phrase in Section 7.3 reads as follows:

> Notwithstanding the provisions of Section 7.1.1, a Partner may sell his interest in the Partnership upon compliance with the conditions of Section 7.1.2 and the following conditions:

CP 71. Mr. Hendricks argued, and the trial court concluded, that the only reasonable interpretation of that language was that a Partner wishing to sell was permitted but not required to comply with the provisions of Section 7.3, and that the Partner could sell without complying with Section 7.3 by simply getting the consent of Partners (other than the selling Partner) owning two-thirds of the remaining interests in the Partnership.

But the word "may" here simply means that: a Partner is permitted but not required to sell his or her interest; but, if he or she does sell, it must be "upon compliance with the conditions of Section 7.1.2 and the following conditions . . . [the rights of first refusal]." Indeed, that is precisely how the word "may" is used in Section 7.2, entitled "Permitted Transfers," which says:

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[11] As discussed above, in the present case, the "trigger" was pulled sometime before May 15, 2012, when Mr. Hendricks notified the Partners that he and Mr. O'Brien had agreed to the sale, or at the very latest May 24, 2012, the date of the execution of the Option Agreement.

> Each Partner may transfer his entire interest in the Partnership without compliance with Section 7.3 to a corporation, all of the capital stock of which is owned by such partner; provided, however, that… [the transferee corporation and its shareholder agree to be bound by the Agreement]

CP 71. This provision obviously means that each Partner is permitted but not required to transfer his or her interest in the Partnership to a wholly owned corporation, but, if he or she chooses to do so, it must be in compliance with the requirement that certain agreements be obtained. The logic, syntax and meaning of the two provisions are the same.

d. The Trial Court's Interpretation Makes the Phrase "Notwithstanding the provisions of 7.1.1 . . ." a Meaningless Redundancy.

It is significant that, while Sections 7.2 and 7.3 are both exceptions to Section 7.1.1, Section 7.2 does not begin with the "trumping" phrase "notwithstanding the provisions of Section 7.1.1." The phrase was not necessary there to convey the meaning that the transfer was permitted despite the general prohibition of 7.1.1.

e. Two-Thirds Consent Is Not a <u>Sufficient</u> Condition to any Transfer.

While prior written consent is a necessary condition to some (but not all) transfers, it is not a sufficient condition to <u>any</u> transfer. It is only required for transfers not otherwise permitted "in this Article VII and Section 8.2." CP 70. The transfers otherwise permitted are:

- Section 7.2 -- "Permitted Transfers" (to a wholly owned corporation);

- Section 7.3 -- "Right of First Refusal" (voluntary sales, Partners have the Right of First Refusal to purchase the Selling Partner's interest);

- Section 7.5 -- "Optional Purchase on Default" (Partnership has the option to purchase the defaulting Partner's interest); and

- Section 8.2 -- "Continuation of the Partnership" (Partnership has the Option to purchase the interest of a withdrawn, deceased or incompetent Partner.)

In all other cases the two-thirds consent is a necessary condition to a transfer, but it is not a sufficient condition. Thus, Section 7.1.2 provides additional conditions applicable to all transfers whether under Article VII or otherwise; Section 7.2 contains additional conditions relating to Permitted Transfers; and Section 7.3 contains additional conditions for a sale by a Partner, specifically the requirements relating to the implementation of Right of First Refusal.

The trial court interpreted Section 7.1.1 as providing a path for a Partner to sell his or her interest, on the sole condition that he or she obtains the consent of Partners holding two-thirds of the Partnership Interests (excluding the interests of the Selling Partner). Even if Section 7.1.1 applies at all in the context of the sale of a Partner's interest, the trial court's conclusion confuses "necessary" and "sufficient" conditions. As a matter of logic, the statement "no Partner may sell without two-thirds consent" establishes that two-thirds consent is a necessary condition to the sale; it does not establish that two-thirds consent is the <u>only</u> condition, or the sufficient condition. The truth of the statement "A only if B" (a Partner may sell only if he or she obtains two-thirds consent) does not permit the inference "if B, then A" (if a Partner obtains two-thirds consent, he or she may sell the interest). See Patrick Hurley, A Concise Introduction to Logic, ch. 6 p. 362 (11^{th} ed. 2012) (discussing the fallacy of "affirming the consequent").[12]

These logical pitfalls can be avoided by recognizing the following. The primary purpose of Section 7.1.1 is to prohibit transfers ("Section 7.1 Transfers Prohibited"). The primary purpose of Section 7.3 is to provide a right of first refusal to all Partners in the event of a sale ("7.3 Right of First Refusal"). The purpose of the two-thirds consent clause in 7.1.1 is simply to ensure that the prohibitions in that section are enforceable.[13] The trial court's interpretation takes a clause designed to ensure the enforceability of prohibitions against transfer, into a device to deny some Partners of their rights under the Partnership Agreement.

f. Every Provision in the Partnership Agreement Dealing Specifically With the Purchase of a Partnership Interest Assures That All Partners Are Treated Equally.

As noted above, there are only four Sections in the Partnership Agreement which deal specifically with a "sale" of a Partnership Interest by a Partner. Sections 7.5 and 8.2 give the Partnership itself the option to purchase the Interest being sold, thereby assuring that all Partners will share in the benefits of the purchase in proportion to their respective Capital Accounts. CP 73, 74. Section 7.3 gives the Partners individually

[12] See also http://en.wikipedia.org/wiki/Affirming_the_consequent

[13] See generally The Enforceability and Effectiveness of Typical Shareholder Agreement Provisions, The Business Lawyer, (Corporation Law Committee of the Association of the Bar of the State of New York), vol. 65, p. 1177 (2010).

the right to choose whether they will be included in the purchase, again in proportion to their respective Capital Accounts. CP 71-72.[14] Section 7.2, permitting a transfer by a Partner to a corporation in which such Partner owns all of the Capital Stock, while technically a sale, does not involve a change in beneficial interests, just a change in the form of ownership. Accordingly, the provision specifically exempts the transaction from the rights of first refusal provided by Section 7.3.

Taken together, these provisions demonstrate a clear intention to assure that the benefits of all sales of Partnership Interests will be available to and shared by all Partners in proportion to their respective Capital Accounts, and that no Partner will receive a preference. The trial court's interpretation allows a subset of the Partners to frustrate that intention and give one partner, Mr. Hendricks, preferential treatment. That interpretation would permit a group of Partners who hold two-thirds of the remaining interests in the Partnership, after excluding those of the selling Partner, to agree with one another to consent to a sale in which they were the only purchasers, depriving the remaining Partners of their right of first refusal. That is an unreasonable and unfair result and frustrates both the intent of the parties and the spirit of the contract. <u>See</u> Restatement (Second) Contracts, § 205 cmt. a ("Good faith performance of a contract emphasizes faithfulness to an agreed common purpose and

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[14] The rights provided by Section 7.3 are to be made available "...to all of the Partners willing to exercise the same <u>without preference and shall be allocated pro rata</u> as determined by the purchasing Partners' respective Capital Accounts..." CP 72-73 (emphasis added).

consistency with the justified expectations of the other party") & d ("the following types [of bad faith] are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain . . .").

g. The "Subsequent Attempts" Rule of Section 7.3.2

Section 7.3.2 provides that, once a Selling Partner provides notice of a proposed sale under Section 7.3.1, and no other Partners wish to exercise their purchase option/right of first refusal, the Selling Partner has thirty days to complete the proposed sale on the terms set forth in the Section 7.3.1 notice. If the Selling Partner wishes to sell after that period, or wishes to sell during the period but on terms that differ from the terms set forth in the notice, the requirements of Section 7.3 "shall again apply to any attempt by the Selling Partner to sell his interest in the Partnership." Id. (emphasis added).

The reference to "again" and "any attempt" indicate that the parties intended Section 7.3 to apply also to the initial "attempt" to sell the interest. It would be senseless for Section 7.3 to forever apply to any subsequent attempt to sell, if it did not also apply to the first attempt.

h. Mr. Hendricks' Contemporaneous Conduct Indicates That He Interpreted Article VII to Confer Rights of First Refusal Whenever a Partner Sold His or Her Interest.

As discussed above, in 1988 Mr. Hendricks orchestrated the communications and documentation related to the 1988 sale of the Biernes Interest. See supra Section III-C. He "immediately" notified the Partners of Biernes' desire to sell its interest and of their right of first refusal and their "option to purchase the share ourselves according to our partnership agreement." Id. He ensured that the proposed sale did not go forward until the Partners had reviewed the proposed terms, considered their rights under Section 7.3.1, and made an informed decision to expressly waive them. Id. Mr. Hendricks' early application of Sections 7.3.1 and 7.1.1 is a highly relevant indicator of what the parties intended when they entered the Partnership Agreement. Scott Paper Worldwide Co., 143 Wn.2d at 364 (relevant extrinsic evidence "includ[es] the subsequent conduct of the contracting parties").

V. CONCLUSION

For the foregoing reasons, RSD requests that this Court reverse the trial court's grant of summary judgment on all claims, and remand this case for trial on the disputed factual issues.

RESPECTFULLY SUBMITTED this 4th day of August, 2014

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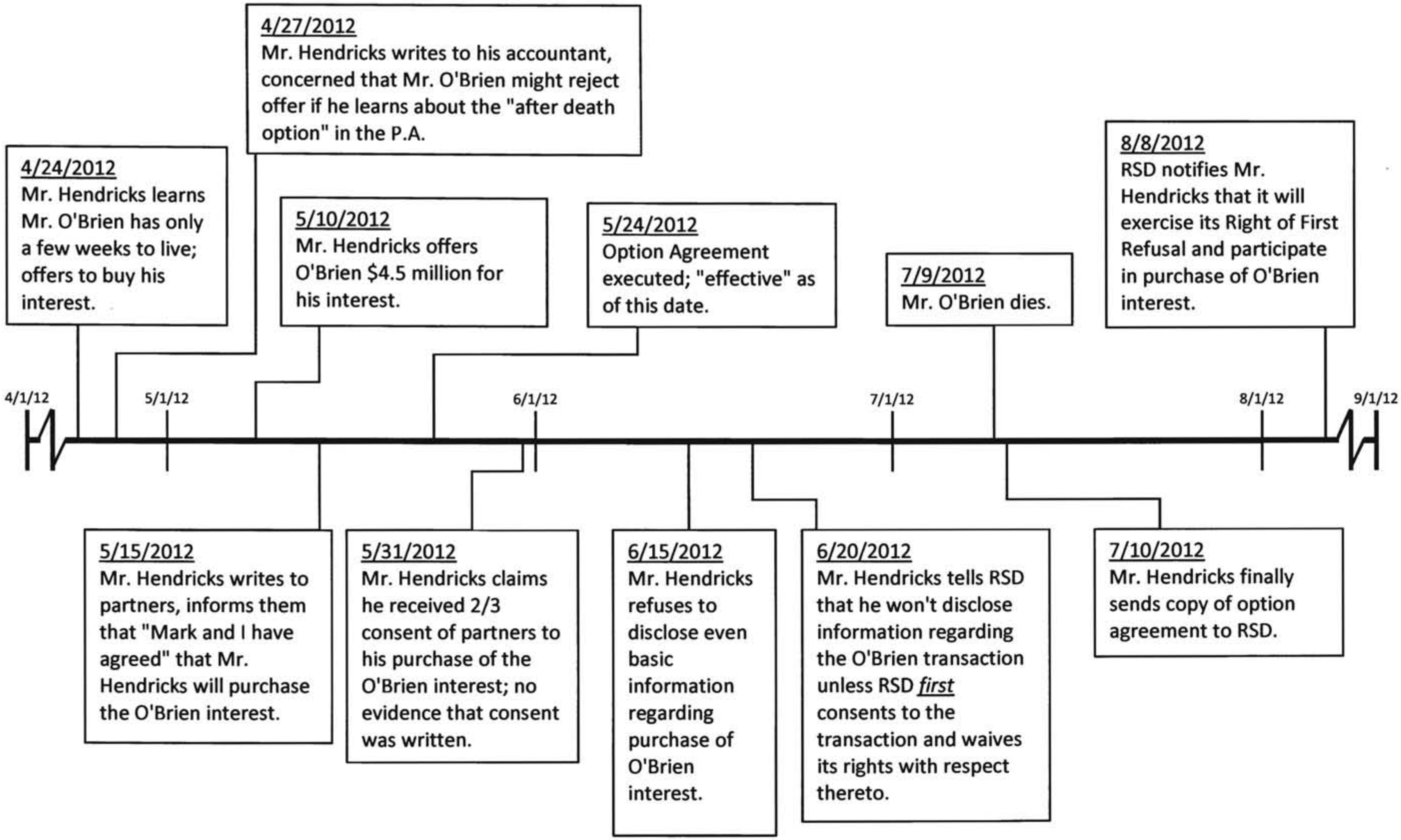
APPENDIX A

Timeline of Events
April - August 2012



No. 71926-2-1

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

RSD AAP LLC,

Plaintiff/Appellant,

vs.

ALYESKA OCEAN, INC.; JEFF HENDRICKS AND JANE DOE HENDRICKS, individually and as a marital community,

Defendants/Respondents.

APPELLANT'S APPENDIX OF NON-WASHINGTON AUTHORITIES

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Appellant hereby submits the following non-Washington authorities cited in its Opening Brief.

1. The Enforceability and Effectiveness of Typical Shareholder Agreement Provisions, The Business Lawyer (Corporation Law Committee of the Association of the Bar of the State of New York), vol. 65 (2010).

2. Finding Safe Harbor: Clarifying the Limited Application of Section 144, Blake Rohrbacher, et al., The Delaware Journal of Corporate Law vol. 33, no.3 (2008).

3. Drafting Matters, Adams, Kenneth A., New York Law Journal (July 5, 2002).

4. "Affirming the Consequent," Wikipedia Entry (August 4, 2014) ((http://en.wikipedia.org/wiki/Affirming_the_consequent).

5. Robert Wise, First Refusal Rights Under Texas Law, 62 Baylor L. Rev. 433 (2010).

RESPECTFULLY SUBMITTED this 4th day of August, 2014

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The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions

By the Corporation Law Committee of the Association of the Bar of the City of New York

Table of Contents

Agreements among two or more shareholders of a corporation are commonly used in connection with private equity and venture capital investments, joint ventures, and other corporate transactions. A shareholders agreement typically grants rights to those shareholders who are party to the agreement that are above and beyond the rights that are inherent in the shares that they own, and is intended to ensure that those shareholders obtain the benefits of the additional rights that they bargained for when making their investments. For example, shareholders agreements may allocate among certain shareholders rights to designate the individuals who will serve on the company's board of directors, grant certain shareholders special voting rights, ensure that certain shareholders have preemptive rights if the company issues additional equity securities, and/or provide rights to limit or participate in transfers of shares by other shareholders, among other things. Although "freedom of contract" is the legal principle that governs many provisions contained in a typical shareholders agreement, there are numerous legal considerations that will affect their enforceability and effectiveness.

The Corporation Law Committee of the Association of the Bar of the City of New York has prepared this Report to highlight many of these legal considerations, with a goal of providing guidance to practitioners drafting these agreements. Many matters addressed by shareholders agreements are governed by, and must comply with, the corporation law of the state of incorporation. Because so many corporations are incorporated in Delaware or New York, this Report will focus primarily on legal considerations arising under shareholders agreements for companies incorporated in these states. If a corporation has been formed in another state, it will, of course, be necessary for the lawyer drafting the shareholders agreement to consider the applicable provisions of the corporation statute of the relevant state. Shareholders agreements are most commonly entered into by shareholders of privately held corporations, so this Report generally discusses agreements among shareholders of a private corporation (unless otherwise indicated). Although agreements among shareholders of close corporations raise similar concerns, the statutory provisions applicable to close corporations are beyond the scope of this Report.

A summary of typical provisions contained in shareholders agreements and certain relevant legal principles and drafting considerations are provided below.

I. Board of Directors

Shareholders agreements typically seek to establish the agreed-upon composition of the board of directors and related corporate governance matters.

A. Shareholders' Nomination and Election of Directors

Shareholders with meaningful ownership positions generally want to ensure that individuals they designate will serve on the corporation's board of directors, both to influence the management of the corporation and to ensure timely access to information about the corporation's activities and prospects.

1. Certain Legal Principles:

- Both the General Corporation Law of the State of Delaware (the "Del. G.C.L.") and the New York Business Corporation Law (the "N.Y.B.C.L.") recognize as valid an agreement between two or more shareholders (if in writing and signed by each) that establishes how the shares held by those shareholders will be voted.[1]

- Whether the corporation is public or private, corporation laws generally require companies to hold annual meetings of shareholders to elect directors, and directors must be elected by the shareholders at these annual meetings.[2]

- Unless otherwise indicated by the corporation's certificate of incorporation or bylaws, directors of Delaware and New York corporations must be elected by a plurality of the votes cast at a shareholders meeting by the holders of shares entitled to vote in the election.[3]

- Election of directors by written consent of the shareholders is permitted, although the relevant corporation law may limit the utility of this procedure. For example, Delaware law permits an election of directors by written consent in lieu of an annual meeting; however, a written consent satisfies the annual meeting requirement for Delaware corporations only if the consent is unanimous or if all directorships are vacant (which can be accomplished by removing all the directors prior to electing the new board by written consent) and are to be filled by the written consent.[4] New York law does not similarly limit the use of a written consent of the shareholders; however, action by less than unanimous written consent must be specifically authorized in the certificate of incorporation.[5]

- Subject to any reasonable procedures set forth in the bylaws, any shareholder present at the annual meeting may nominate any individual for election as a director.[6] Most modern public corporations and many private corporations have bylaws that require shareholders to comply with advance notice procedures for the nomination of directors, so there are limitations on shareholders' ability to nominate directors at the annual meeting. N.Y.B.C.L. section 602(d) expressly provides that the bylaws may specify "reasonable procedures for the . . . conduct of a meeting of shareholders, including . . . the procedures and requirements for the nomination of directors."[7] Del. G.C.L. section 109, which provides that the bylaws may contain provisions relating to the rights and powers of shareholders,

1. DEL. CODE ANN. tit. 8, § 218(c) (2001); N.Y. BUS. CORP. LAW § 620(a) (McKinney 2003).
2. *See* DEL. CODE ANN. tit. 8, § 211(b) (2001); N.Y. BUS. CORP. LAW § 602(b) (McKinney 2003).
3. DEL. CODE ANN. tit. 8, § 216(3) (2001); N.Y. BUS. CORP. LAW § 614(a) (McKinney 2003 & Supp. 2010).
4. DEL. CODE ANN. tit. 8, § 211(b) (2001).
5. N.Y. BUS. CORP. LAW § 615(a) (McKinney 2003).
6. *See id.* § 605(a) (requiring notice of purpose for special meetings but not for annual meetings); JANA Master Fund, Ltd. v. CNET Networks, 954 A.2d 335, 344 (Del. Ch. 2008).
7. N.Y. BUS. CORP. LAW § 602(d) (McKinney 2003).

has been interpreted as permitting advance notice bylaws if they do not unduly restrict the stockholder franchise and are applied equitably.[8]

2. Drafting Considerations:

- Shareholders agreements often create rights to "designate" or "appoint" directors. However, to conform with legal requirements that directors be "elected" by shareholders, the shareholders agreement should set forth the process by which individuals are *nominated* by the shareholders, as well as the agreement of the shareholders party to the agreement to vote their shares to elect those nominees as directors. The agreed-upon procedures required for those shareholders to nominate directors should also be set forth in the corporation's certificate of incorporation or bylaws (or incorporated by reference to the shareholders agreement) in a provision that cannot be amended except as permitted by the shareholders agreement. The shareholders agreement may also include a grant of a proxy to the nominating shareholder by the other shareholders to allow the nominating shareholder to vote the other shareholders' shares in favor of its nominated director(s). Without a proxy, a voting agreement may not be specifically enforceable.[9] As the laws governing the validity of proxies vary from state to state, the draftsperson should confirm when drafting a proxy that it complies with applicable state laws.
- A shareholders agreement may include a provision to reduce or eliminate a shareholder's right to nominate a director as its ownership interest declines, and a provision for termination of the nomination rights and voting obligations (usually upon an initial public offering, but other circumstances may also terminate these provisions).

B. Removal of Directors

An important corollary to a shareholder's right to designate a director is its right to remove that director and substitute a successor. Removal is also relevant when a shareholder's right to designate a director has terminated pursuant to the terms of the shareholders agreement.

1. Certain Legal Principles:

- In Delaware, subject to certain exceptions, directors may be removed *without cause* by shareholders owning a majority of the outstanding shares

8. Del. Code Ann. tit. 8, § 109 (2001); *see, e.g.*, *JANA Master Fund*, 954 A.2d at 344; Accipiter Life Scis. Fund, L.P. v. Helfer, 905 A.2d 115, 124–25 (Del. Ch. 2006) ("[A]dvance notice bylaws . . . must on their face and in the particular circumstances 'afford the shareholders a fair opportunity to nominate candidates.'" (quoting Hubbard v. Hollywood Park Realty Enters., Inc., No. 11779, 1991 WL 3151, at *11 (Del. Ch. Jan. 14, 1991))).

9. *See* Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 53 A.2d 441, 447–48 (Del. 1947).

entitled to vote at an election of directors.[10] Under New York law, however, directors may be removed *without cause* by shareholders only if the certificate of incorporation or bylaws so provide.[11]

- For both Delaware and New York corporations, directors may be removed *for cause* by shareholders owning a majority of the outstanding shares entitled to vote at an election of directors.[12] In addition, in New York, directors may also be removed by the board *for cause* if permitted by the certificate of incorporation or a bylaw adopted by the shareholders.[13]
- In Delaware, directors may be removed through written consent (unless prohibited in the certificate of incorporation) by shareholders owning a majority of the outstanding shares entitled to vote at an election of directors.[14] New York corporations can provide for this rule in their certificate of incorporation; otherwise, unanimous written consent is required for removal.[15]
- Removal rights of the shareholders and, in the case of New York corporations, the powers of the board to remove directors may be limited if the board is classified, if the corporation has cumulative voting, or if directors are elected by a class or series of shares.[16]

2. Drafting Considerations:

The certificate of incorporation or bylaws, as appropriate, should ensure that shareholders will be able to remove the directors they nominate, with or without cause (in accordance with the shareholders agreement). Each shareholder should agree in the shareholders agreement that it *will not* vote or execute a written consent to remove a director nominated by another shareholder, usually whether with or without cause, unless the shareholder that nominated that director requests the removal. Conversely, each shareholder should agree that it *will* vote or execute a written consent to remove a director if requested by the shareholder that nominated that director. Some agreements may permit other shareholders to remove a director for cause, in which case the standard of conduct that constitutes "cause" should be carefully considered to avoid later disagreements.

C. Filling Board Vacancies

The complement of being able to remove a designee is the assurance of being able to install a replacement.

10. Del. Code Ann. tit. 8, § 141(k) (2001).
11. N.Y. Bus. Corp. Law § 706(a), (b) (McKinney 2003).
12. Del. Code Ann. tit. 8, § 141(k) (2001); N.Y. Bus. Corp. Law § 706(a) (McKinney 2003).
13. N.Y. Bus. Corp. Law § 706(a) (McKinney 2003). Delaware, on the other hand, does not allow directors to remove other directors.
14. Del. Code Ann. tit. 8, §§ 141(k), 228(a) (2001).
15. N.Y. Bus. Corp. Law § 615(a) (McKinney 2003).
16. Del. Code Ann. tit. 8, § 141(k) (2001); N.Y. Bus. Corp. Law § 706(a), (c) (McKinney 2003).

1. Certain Legal Principles:

Unless otherwise provided in the certificate of incorporation or bylaws, the board of directors generally may fill any vacancy itself (including vacancies created by resignation or removal and newly created directorships).[17] In Delaware, this is true whether the director was removed for cause or without cause. In New York, however, a vacancy on the board resulting from a removal of a director without cause must be filled by the shareholders, unless the certificate of incorporation or a shareholder-adopted bylaw gives the board a right to fill such a vacancy.[18]

2. Drafting Considerations:

To ensure the efficacy of the designating shareholder's right to select the successor, the shareholders should be given (i) in the certificate of incorporation or bylaws, the exclusive right to nominate and elect directors to fill vacancies; (ii) in the certificate of incorporation or bylaws, the right to call a special meeting of the shareholders for the purpose of filling vacancies; and (iii) in the bylaws, a right granted to the shareholder who designated the director whose seat has become vacant to nominate an individual to fill the vacancy; and the shareholders should agree in the shareholders agreement to vote for the directors so nominated.[19] Of course, this procedure will be effective only if shareholders holding at least a plurality in voting power are parties to the shareholders agreement. In each case, the certificate of incorporation and/or bylaws should require that any such provisions may be amended only by the shareholders whose consent would be required to amend the corresponding provision of the shareholders agreement.

D. Board Size, Quorum, and Voting

Shareholders agreements typically address board size, as well as the quorum and voting requirements for decisions by the board. These provisions should work together to ensure that the viewpoints of a sufficient number of shareholder designees are considered before the board takes any action, but without adversely

17. *See* Del. Code Ann. tit. 8, § 223(a) (2001 & Supp. 2008); N.Y. Bus. Corp. Law § 705 (McKinney 2003).

18. N.Y. Bus. Corp. Law § 705(b) (McKinney 2003).

19. Sometimes shareholders agreements provide that vacancies in directorships of designated directors be filled only by other directors nominated by the same stockholder. The validity of this type of provision under the Del. G.C.L. is questionable, unless such directors are constituted as a committee of the board that is empowered to fill such vacancies. Likewise, a provision that commits the board to fill a vacancy with a person nominated by a specific shareholder is subject to the board's fiduciary duties. *See In re* Aquila Inc. S'holders Litig., 805 A.2d 184, 193 (Del. Ch. 2002) (recognizing that directors owe fiduciary duties when filling vacancies). This issue can be avoided if the right to fill vacancies is vested in the shareholders, with the designating shareholder having the right to nominate the replacement to fill the vacancy and the other shareholders being bound to vote in favor of such nominee. *See generally* Campbell v. Loew's, Inc., 134 A.2d 852, 857 (Del. Ch. 1957) (stating that the permissive language of Del. G.C.L. section 223(a) "does not prevent the stockholders from filling the new directorships" or other vacancies).

affecting the effectiveness of the board or fostering deadlocks. Potential changes in board size should also be addressed, so the board cannot circumvent the quorum and voting requirements that have been agreed to by the shareholders.

1. Legal Principles—Board Size:

Delaware law provides that the certificate of incorporation may fix the number of directors, and unless so fixed, the number shall be fixed by, or in the manner provided in, the bylaws.[20] Delaware case law makes clear that the certificate of incorporation can provide for a range of board sizes, with the exact size within that range fixed by the board of directors.[21] New York law provides that the number of directors may be fixed by the bylaws, by action of the shareholders, or by the board if empowered by a bylaw adopted by the shareholders.[22]

2. Drafting Considerations—Board Size:

Board size, whether a fixed number or a range, should be set forth in a bylaw that cannot be amended without the same shareholder approval required to amend the comparable provision of the shareholders agreement. In Delaware, board size alternatively may be set forth in the certification of incorporation. The shareholders should agree in the shareholders agreement that they will not vote in favor of any change to the certificate of incorporation or bylaws that would be inconsistent with any provision of the shareholders agreement.

3. Certain Legal Principles—Quorum Requirement:

Generally, a majority of the total number of directors constitutes a quorum.[23] However, both Delaware and New York law permit changes to the quorum requirement, although the requirement cannot be less than one-third of the entire board.[24] For a Delaware corporation, a provision *increasing* the requirement for a quorum may be contained in the corporation's certificate of incorporation or bylaws.[25] A provision *decreasing* the quorum requirement may be contained in the bylaws, unless the certificate of incorporation provides otherwise.[26] For a New York corporation, a provision *increasing* the percentage of the board constituting a quorum must be contained in the certificate of incorporation, while a provision *decreasing* the quorum requirement may be contained in the certificate of incorporation or bylaws.[27]

20. Del. Code Ann. tit. 8, § 141(b) (2001 & Supp. 2008).

21. *See* Henley Group, Inc. v. Santa Fe S. Pac. Corp., No. 9569, 1988 WL 23945, at *16–19 (Del. Ch. Mar. 11, 1988).

22. N.Y. Bus. Corp. Law § 702(a) (McKinney 2003).

23. *See* Del. Code Ann. tit. 8, § 141(b) (2001 & Supp. 2008); N.Y. Bus. Corp. Law § 707 (McKinney 2003).

24. *See supra* note 23.

25. Del. Code Ann. tit. 8, § 141(b) (2001 & Supp. 2008).

26. *Id.*

27. N.Y. Bus. Corp. Law § 707 (McKinney 2003).

4. Drafting Considerations—Quorum Requirement:

The number of directors necessary to constitute a quorum of the board should be set forth in the certificate of incorporation or a bylaw that cannot be amended without shareholder approval. If future changes to the quorum requirement are contemplated by the shareholders agreement, the certificate of incorporation or bylaws should provide for such changes. If specified directors are required for a quorum to be present, this provision must be included in the certificate of incorporation.[28]

5. Certain Legal Principles—Voting Requirement:

Any action by the board of directors generally requires either the approval of a majority of the directors who are present at a meeting at which a quorum is present, or a written consent approved by all directors.[29] For certain items, shareholders may desire a supermajority vote of the directors rather than a simple majority. The voting requirement for the board of directors may be greater (but not less) than the majority requirement established by statute, but only if set forth in the certificate of incorporation or bylaws.[30] In addition, a recent amendment to Delaware law would permit the certificate of incorporation (but not the bylaws) to require that the approval of one or more specified directors is required to take particular actions and/or that one or more directors may have more or less than one vote per director on any matter.[31]

6. Drafting Considerations—Voting Requirement:

A shareholders agreement alone cannot create or modify the majority voting requirement for actions by the board of directors. Accordingly, if the shareholders agree that the approval of a supermajority of directors should be required to authorize any action, this requirement should be specified in the corporation's certificate of incorporation or a bylaw that cannot be amended without shareholder approval. All shareholders party to the shareholders agreement should agree to vote their shares on any amendment to the certificate of incorporation or bylaws only if consistent with the provisions of the shareholders agreement.

E. Limiting the Powers of the Board of Directors

The corporation law statutes generally grant to the directors broad discretion to manage the business and the affairs of the corporation within the parameters set forth in the certificate of incorporation and bylaws, but the shareholders may

28. *See* Del. Code Ann. tit. 8, § 141(d) (2001 & Supp. 2008).

29. *See id.* § 141(b), (f); N.Y. Bus. Corp. Law § 708(b), (d) (McKinney 2003).

30. *See* Del. Code Ann. tit. 8, § 141(b) (2001 & Supp. 2008); N.Y. Bus. Corp. Law § 709(a)(2) (McKinney 2003).

31. Del. Code Ann. tit. 8, § 141(d) (2001 & Supp. 2008).

prefer to retain this power and/or limit the board's discretion and reflect these preferences in the shareholders agreement.

1. Certain Legal Principles:

- In New York, directors are able to amend or repeal a bylaw that has been adopted by the shareholders only if there is a specific grant of such authority in the certificate of incorporation or bylaws.[32]
- The Del. G.C.L. has no comparable provision. However, because directors of a Delaware corporation do not have the power to amend the bylaws unless the authority to do so is granted in the certificate of incorporation,[33] a provision in the certificate of incorporation that gives the board the power to adopt, amend, or repeal the bylaws could be drafted to limit the board's ability to amend any bylaws that were adopted by shareholders. In the absence of such a limitation, except in the case of the shareholder-adopted bylaws relating to the vote required to elect directors (which cannot be amended by the board),[34] it is likely that a certificate of incorporation provision granting the board the power to "adopt, amend, or repeal the bylaws" would be interpreted as granting the board the power to amend any bylaws, including those adopted by the shareholders, subject to the board's fiduciary duties.[35]

2. Drafting Considerations:

- If the shareholders desire to limit or eliminate the board's powers to address matters that the corporation law statute would allow the board to address if specified in the certificate of incorporation or bylaws, the shareholders should ensure that the certificate of incorporation and bylaws contain express limitations on the board's discretion in the relevant circumstances. Moreover, the shareholders agreement should provide that each shareholder agrees not to vote its shares for any change to the certifi-

32. N.Y. Bus. Corp. Law § 601(a) (McKinney 2003).

33. Del. Code Ann. tit. 8, § 109 (2001).

34. Del. Code Ann. tit. 8, § 216 (2001 & Supp. 2008).

35. *See* Bebchuck v. CA, Inc., 902 A.2d 737, 743 n.37 (Del. Ch. 2006); Gen. DataComm Indus., Inc. v. Wis. Inv. Bd., 731 A.2d 818, 821 n.1 (Del. Ch. 1999) ("The question of whether a stockholder-approved bylaw may be repealed by a board of directors . . . has not clearly been answered by a Delaware court. However, the Supreme Court's decision in *Centaur Partners* . . . and the views of a learned commentator [Hamermesh] suggest that the affirmative answer may be the correct one."); *In re* Nat'l Intergroup, Inc. Rights Plan Litig., Nos. 11484, 11511, 1990 WL 92661, at *7 (Del. Ch. July 3, 1990); Am. Int'l Rent a Car, Inc. v. Cross, No. 7583, 1984 WL 8204, at *3 (Del. Ch. May 9, 1984) ("If a majority of American International's stockholders in fact disapproved of a Board's amendment of the bylaw, several resources were, and continue to be, available to them. They could vote the incumbent directors out of office. Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.").

cate of incorporation or bylaws unless the level of shareholder approval set forth in the shareholders agreement is satisfied.

- Although some shareholders agreements purport to require each shareholder to cause its designated director(s) to vote in a particular way on specified matters, this approach will not ensure that the shareholders will realize the benefit of this bargained-for right, because the directors will have fiduciary duties to act in the best interests of the corporation and all of its shareholders, notwithstanding the desires of any particular shareholder. These fiduciary duties cannot be overridden by private agreement. A somewhat better approach is to require in the certificate of incorporation that certain actions cannot be taken except with stockholder approval, as non-controlling stockholders are generally free to vote in their own interest without fiduciary duty constraints.[36] A less effective approach is to require that the corporation be party to the shareholders agreement, with an obligation not to take specified actions except with the consent of a requisite number of shareholders. This is not as effective as a limitation in the certificate of incorporation or a bylaw provision that cannot be amended without the consent of the shareholders, because the corporation would retain authority to take the specified actions. However, the shareholders party to the shareholders agreement would have a claim against the corporation for breach of the shareholders agreement if the board of directors authorizes, and the corporation takes, any of the specified actions without obtaining the requisite shareholder consent. If the shareholders learn of a possible breach in advance, a court might also be willing to grant an injunction to prevent the action from being taken in violation of the shareholders agreement, because damages would be difficult to determine.[37]

F. Board Committees

Corporation laws generally grant power to the board of directors in its entirety, but they permit boards to delegate authority to committees with respect to certain matters. Although board committees may generally exercise all of the powers of the board of directors, there are limitations.

1. Certain Legal Principles:

- A resolution of the board of directors or the bylaws of a Delaware corporation may establish any committee of the board to exercise the power and authority of the board, but a committee of the board of a Delaware corporation cannot have the power to (i) approve or adopt, or recommend to

36. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987). *But see* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114 (Del. 1994) (controlling stockholder owes fiduciary duties to the corporation and minority stockholders).

37. *See* Brinati v. TeleSTAR, Inc., No. 8118, 1985 WL 44688, at *4 (Del. Ch. Sept. 3, 1985).

the shareholders, any matter that is expressly required by the Del. G.C.L. to be submitted to stockholders for approval (other than the election or removal of directors) or (ii) adopt, amend, or repeal any bylaw.[38] Shareholders may adopt bylaws that limit the powers that a board may grant to a committee and regulate the process by which a board acts through a committee.[39]

- The power of the board of directors of a New York corporation to establish committees must be granted to the board by the certificate of incorporation or bylaws.[40] With this grant, a resolution of a majority of the entire board of directors can establish a committee that would have the authority of the board.[41] However, a committee of the board of a New York corporation cannot have the power to (i) submit to shareholders any action that requires shareholder approval under any provision of the N.Y.B.C.L.; (ii) fill any board or committee vacancies; (iii) fix director compensation; (iv) amend or repeal the bylaws or adopt new bylaws; or (v) amend or repeal any board resolution that by its terms is not so amendable or repealable.[42]

2. Drafting Considerations:

If a shareholders agreement provides that directors who were nominated by particular shareholders must be included as members of specified board committees, it is preferable that this requirement, or a requirement that committees include directors nominated by specified shareholders in order to be validly constituted, also be included in the certificate of incorporation or a bylaw provision that cannot be amended without shareholder approval, to limit clearly the authority of the board to establish a committee with a different composition. An alternative would be to have in place protective quorum and voting requirements for the board in the certificate of incorporation or bylaws so that a significant majority of directors must agree before committee members can be named or replaced. In addition, as noted above, the certificate of incorporation (but not the bylaws) of a Delaware corporation could require the consent of specified directors to constitute or change committee membership. The shareholders agreement may also require that shareholders take all actions necessary to require the board to comply with committee composition requirements contained in the shareholders agreement (requiring shareholders to vote to remove any director that takes any action inconsistent with such requirement).

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38. Del. Code Ann. tit. 8, § 141(c)(1)–(2) (2001).

39. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1079 (Del. Ch. 2004) (shareholders may adopt bylaws, if equitable, eliminating a board committee after it has been created).

40. N.Y. Bus. Corp. Law § 712(a) (McKinney 2003).

41. *Id.*

42. *Id.*

G. Board Observer Rights

Many shareholders agreements give one or more shareholders a right to appoint an observer to attend board meetings and receive information that is otherwise sent to directors. These rights may be granted immediately or may arise after the shareholder's ownership falls below the minimum ownership percentage required to designate a director, and they are particularly common when the shareholder is an investment fund seeking to qualify as a "venture capital operating company" under ERISA. An observer does not have the right to vote on matters voted upon by the board. Likewise, because an observer is not a member of the board, the fiduciary duties applicable to board members are not applicable to observers.

1. Certain Legal Principles:

Neither the Del. G.C.L. nor the N.Y.B.C.L. expressly references board observers, so they do not have any statutory rights, obligations, or powers.

2. Drafting Considerations:

If a shareholders agreement provides for an observer, the agreement should also include provisions to protect the corporation. For example, the shareholders agreement should require that an observer enter into a confidentiality agreement as a condition to the observer's appointment. The shareholders agreement should also allow the corporation to exclude an observer from any meeting where inclusion would cause the corporation to lose a right or otherwise prejudice the corporation: for example, where a meeting involves a discussion of privileged matters and the participation of an observer in such meeting could result in a waiver of the privilege.

H. Indemnification

To assure shareholders that the corporation will provide adequate indemnification for the directors they nominate and elect, shareholders agreements frequently require that the corporation provide directors the maximum indemnification permitted by applicable law. Some shareholders agreements also require the corporation to obtain director and officer liability insurance.

1. Certain Legal Principles—Indemnification of Directors Generally:

- Both the Delaware and New York statutes authorize corporations generally to indemnify their current and former directors against expenses (including attorney's fees), judgments, fines, and settlement payments that are reasonably incurred by the director in connection with any threatened, pending, or completed civil or criminal action, suit, or proceeding brought because he or she is or was a director, and permit corporations to pay the director's expenses (including attorney's fees) in defending any such proceedings, in advance of final disposition, if the director agrees to reimburse the corporation if it is later determined that he or she was not entitled to indemnity.[43]

- Once a director is successful in defending an action, suit, or proceeding, the corporation is required to indemnify that person for expenses (including attorney's fees) that are actually and reasonably incurred.[44] Prior to a successful conclusion, however, this indemnification is not self-executing—i.e., the corporation has the authority, but is not required, to provide such indemnification unless this requirement is expressly provided pursuant to the corporation's certificate of incorporation, bylaws, a resolution of the board of directors, or an agreement between the corporation and the director(s).[45]
- An agreement that obligates the corporation to indemnify or advance expenses to directors beyond what is described in the applicable statute may be enforceable.[46]
- Although the Delaware Court of Chancery recently ruled that a corporation may amend a bylaw provision to deny a former director the right to advancement of expenses, without the consent of the former director, if the amendment was effected in accordance with the bylaws,[47] this case was essentially overruled by a 2009 amendment to Del. G.C.L. section 145(f). This new provision requires that, absent a provision allowing for retroactive elimination or impairment, directors are entitled to indemnification and advancement of expenses as provided in the certificate of incorporation or bylaws at the time the act or omission occurs, even if the provision granting such entitlement is subsequently amended or repealed.[48]

2. Drafting Considerations—Indemnification of Directors Generally:

Shareholders should include in the shareholders agreement a requirement that the corporation provide indemnification and advancement of expenses for

43. DEL. CODE ANN. tit. 8, § 145(a), (c), (e) (2001); N.Y. BUS. CORP. LAW §§ 722, 723(c) (McKinney 2003).

44. DEL. CODE ANN. tit. 8, § 145(c) (2001); N.Y. BUS. CORP. LAW § 723(a) (McKinney 2003).

45. DEL. CODE ANN. tit. 8, § 145 (2001 & Supp. 2010); N.Y. BUS. CORP. LAW § 723(b) (McKinney 2003).

46. *See* DEL. CODE ANN. tit. 8, § 145(f) (2001 & Supp. 2010); *see also* Levy v. HLI Operating Co., 924 A.2d 210, 226 n.59 (Del. Ch. 2007) ("Under [section] 145(f), a corporation may provide indemnification rights that go 'beyond' the rights provided by . . . the other substantive subsections of [section] 145. At the same time, such indemnification rights provided by a corporation must be 'consistent with' the substantive provisions of [section] 145 . . . ." (quoting Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 91 (2d Cir. 1996)) (alterations and ellipses in original)).

47. Schoon v. Troy Corp., 948 A.2d 1157, 1166–67 (Del. Ch.), *motion to vacate denied sub nom.* Bohnen v. Troy Corp., 962 A.2d 916 (Del. 2008).

48. DEL. CODE ANN. tit. 8, § 145(f) (2001 & Supp. 2010).

directors to the maximum extent permitted by applicable law. In addition, shareholders should ensure that the corporation's certificate of incorporation or bylaws require such indemnification and advancement of expenses *and* that these provisions cannot be amended to adversely affect any director without the consent of that director (at least in the case of a non-Delaware corporation). Alternatively (or in addition), the shareholders should require indemnification agreements between the corporation and each director, which cannot be amended without the consent of the applicable director.

3. Certain Legal Principles—Multiple Indemnitors:

A Delaware court recently held that if an individual serving on a board of directors is indemnified both by the corporation and by a third party (for example, by both the corporation and the shareholder that nominated the individual to serve on the board), neither indemnitor would be solely liable to the individual; instead, each indemnitor is equally liable.[49]

4. Drafting Considerations—Multiple Indemnitors:

When representing a shareholder with a right to nominate a director to serve on the board, counsel should ensure that the director indemnification provisions in the corporation's certificate of incorporation, bylaws, or indemnification agreement with the director specify that the corporation is the primary indemnitor for any claims against the director, and that the director need not pursue other secondarily available indemnification prior to seeking indemnification from the corporation.[50] If the shareholders agreement also includes indemnification of shareholders, counsel should include language in the shareholders agreement that makes it clear that the indemnity of the shareholders includes any amounts expended by a shareholder to indemnify its designated director in connection with his or her service as a director. In this way, the shareholder can avoid sharing the indemnification liability with the corporation.

II. Corporate Opportunities

Shareholders often seek a waiver of corporate opportunities in shareholders agreements, particularly when the shareholders are investors who may seek

49. *Levy*, 924 A.2d at 226–27 (when directors have been indemnified by both the corporation and an investment fund, and the investment fund settled claims on behalf of the directors, the directors are not entitled to pursue indemnification claims against the corporation, but the investment fund is entitled to equitable contribution to require the corporation to pay its fair share of the settlement amount).

50. *See* Sodano v. Am. Stock Exch. LLC, No. 3418-VCS, 2008 WL 2738583, at *14–16 (Del. Ch. July 15, 2008) (when a parent's organizational documents include a prioritization/set-off provision that clearly indicates that its indemnity obligations are secondary to the indemnity obligations of its subsidiary, then the indemnitors are not co-indemnitors with co-equal obligations), *aff'd sub nom.* Am. Stock Exch. LLC v. FINRA, 970 A.2d 256 (Del. 2009) (unpublished table decision).

similar investment opportunities or who already hold investments in entities that are in a similar line of business to the corporation. Shareholders agreements often set forth ground rules as to how corporate opportunities are to be treated.

A. Certain Legal Principles

- Under New York law, a corporate fiduciary "may not, without consent, 'divert and exploit for his or her own benefit any opportunity that should be deemed an asset of the corporation.'"[51] New York courts have held that silence may constitute consent for purposes of the corporate opportunity doctrine.[52] Similarly, under Delaware law, a corporate fiduciary may not seize an "opportunity . . . within the corporation's line of business" when the corporation has an "interest or expectancy" in that opportunity.[53]
- The key determination as to whether the opportunity should be deemed an asset of the corporation is whether the corporation had a "tangible expectancy" in the opportunity, which has been explained as something "'much less tenable than ownership,' but, on the other hand, more certain than a 'desire' or a 'hope.'"[54]
- There is some authority in New York that supports the contention that a fiduciary cannot be liable for usurping a corporate opportunity where the corporation would have been unable to avail itself of the opportunity—for example, if a third party refused to deal with the corporation or if the corporation was not financially able to take advantage of the opportunity.[55] However, there is other authority in New York suggesting that even if the corporation could not undertake the opportunity for itself, a fiduciary may not then take the opportunity for himself or itself, except with the consent of the corporation.[56] Under Delaware law, the corporation must be "financially able to exploit the opportunity."[57]

51. Young v. Chiu, 853 N.Y.S.2d 575, 576 (App. Div. 2008) (quoting Commodities Research Unit (Holdings) Ltd. v. Chem. Week Assocs., 571 N.Y.S.2d 253, 254 (App. Div. 1991)).

52. *See, e.g.*, Ackerman v. 305 E. 40th Owners Corp., 592 N.Y.S.2d 365, 367 (App. Div. 1993) (board is estopped from alleging that director diverted a corporate opportunity where he previously disclosed his intention to the board, and the board did not object until several months after the transaction in question was completed).

53. McGowan v. Ferro, 859 A.2d 1012, 1038 (Del. Ch. 2004).

54. Alexander & Alexander of N.Y., Inc. v. Fritzen, 542 N.Y.S.2d 530, 534 (App. Div. 1989) (citation omitted).

55. *See, e.g.*, Moser v. Devine Real Estate, Inc. (Fla.), 839 N.Y.S.2d 843, 848 (App. Div. 2007).

56. *See* Foley v. D'Agostino, 248 N.Y.S.2d 121, 129 (App. Div. 1964); *see also* Bankers Trust Co. v. Bernstein, 563 N.Y.S.2d 821, 822 (App. Div. 1991).

57. *McGowan*, 859 A.2d at 1038.

- The Del. G.C.L. was amended in 2000 to give a Delaware corporation the power to renounce, in its certificate of incorporation or by board resolution, any interest or expectancy in specified business opportunities or specified classes of business opportunities that are offered to the corporation or one or more of its officers, directors, or shareholders.[58] Accordingly, a Delaware corporation may renounce in a shareholders agreement the corporation's interest in specified business opportunities or classes or categories of business opportunities and thereby permit its officers, directors, and shareholders to pursue opportunities that might otherwise be required to be presented to the corporation.
- Recent case law has suggested that language exculpating directors from liability for keeping corporate opportunities for themselves, or for other affiliates, rather than renouncing opportunities, may not be authorized under Del. G.C.L. section 122(17).[59]

B. Drafting Considerations

If the corporation is a Delaware corporation, Del. G.C.L. section 122(17) permits the corporation to renounce corporate opportunities, but shareholders should recognize that a provision in a shareholders agreement may be insufficient for this purpose, unless the corporation is a party to the agreement. Instead, the shareholders should ensure that the corporation's certificate of incorporation or a resolution of the board renounces specified opportunities or classes of opportunities. Because the N.Y.B.C.L. does not include a provision similar to Del. G.C.L. section 122(17), it is unclear whether a renunciation of corporate opportunities, even if contained in a certificate of incorporation or bylaw, would be effective for a New York corporation.

III. Appointment and Removal of Officers

Often, shareholders agreements give shareholders rights to influence the selection and removal of key officers of the corporation.

A. Certain Legal Principles

- Although officers generally are appointed by the corporation's board of directors, the manner for choosing officers of a Delaware corporation must be prescribed by the bylaws or by resolution of the board of directors.[60] In New York, the corporation's board may elect or appoint officers, but the

58. *See* Del. Code Ann. tit. 8, § 122(17) (2001).

59. *See* Wayne County Employees' Ret. Sys. v. Corti, No. 3534-CC, 2009 WL 2219260, at *17–19 (Del. Ch. July 24, 2009).

60. Del. Code Ann. tit. 8, § 142(b) (2001).

certificate of incorporation may provide that officers are elected by shareholders instead of the board.[61]

- Under New York law, an officer elected or appointed by the board may be removed by the board with or without cause.[62] An officer elected by the shareholders may be removed with or without cause only by the vote of the shareholders, but any officer's authority to act may be suspended by the board for cause.[63] There is no similar limitation under Delaware law on the board's right to remove an officer.

B. Drafting Considerations

Shareholders may agree in a shareholders agreement upon a manner for selecting officers, such as requiring the consent of a particular shareholder or group of shareholders for the selection of certain officers, but the bylaws (or, in the case of a New York corporation, the certificate of incorporation) should describe the agreed-upon manner. Shareholders should recognize, however, that if they appoint officers, the board of a Delaware corporation retains authority to remove the officers selected by the shareholders, and the board of a New York corporation may suspend an officer for cause. However, the certificate of incorporation could provide that consent of stockholders as a group or specified stockholders is required to remove certain officers.

IV. Special Voting Rights

Shareholders agreements commonly include provisions that prohibit the corporation from taking specified actions unless it obtains the approval of certain shareholders or a percentage of the shareholders and/or the approval of certain directors or a percentage of the directors designated by certain shareholders. The types of action that require this incremental approval level will vary, depending in part on the composition and concentration of the shareholders. For example, a majority shareholder who controls the board may conclude that it does not need contractual approval requirements, whereas a minority shareholder may require the right to approve specified actions as a means of protecting its investment.

A. Certain Legal Principles

Board members have fiduciary duties and thus must make decisions that are in the interest of the corporation and all shareholders, even if the shareholder that he or she is representing disagrees with that decision.

61. N.Y. Bus. Corp. Law § 715(a), (b) (McKinney 2003).
62. *Id.* § 716(a).
63. *Id.*

B. Drafting Considerations

- Approval rights are often granted to shareholders because, unlike directors, they can vote their shares in their own interest and have no fiduciary duty to other stockholders in exercising their right to vote.[64]
- If the shareholders desire special voting rights, consideration should be given to including those provisions in the certificate of incorporation. If the approval requirement is contained in the corporation's certificate of incorporation and the corporation fails to obtain the requisite shareholder approval, the action will be *ultra vires* and thus not a valid action of the corporation.[65] Simply including the voting provisions in a shareholders agreement to which the corporation is a party may not be as effective.[66] The potential disadvantages of including shareholder approval requirements in the certificate of incorporation include the incremental burden of soliciting and obtaining the necessary consents and of filing the amendment to the certificate of incorporation, particularly if there is a large number of shareholders. The heightened protection of having such rights in the certificate of incorporation should be weighed against the potential inconvenience and cost of amending the certificate of incorporation. Another consideration, which may be an advantage or disadvantage, is the fact that a certificate of incorporation is publicly available, whereas a shareholders agreement typically is not.
- The shareholders agreement (and certificate of incorporation, if applicable) often reduces or eliminates approval rights as the shareholder's ownership interest declines.

V. Information Rights

Shareholders agreements often contain rights of the shareholders to obtain certain financial data or other types of information. Shareholders agreements may also provide shareholders with a right of access to the corporation's management and advisors, although such rights are typically granted only to shareholders holding more than a minimum percentage of the outstanding shares. These rights are independent of the right of any shareholder who is also a director to obtain information and interact with management and advisors in his or her capacity as a member of the board.

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64. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987). *But see* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114 (Del. 1994) (controlling stockholder owes fiduciary duties to the corporation and minority stockholders).

65. *See* Solomon v. Armstrong, 747 A.2d 1098, 1114 n.45 (Del. Ch. 1999) (voidable acts under the *ultra vires* doctrine include those that are "prohibited by the corporation's charter, for which no implicit authority may be rationally surmised"). *But see* Fletcher Int'l Ltd. v. Ion Geophysical Corp., No. 5109-VCP (Del. Ch. Mar. 24, 2010) (denying injunctive relief because damages may be adequate remedy for breach of consent rights under certificate of incorporation).

66. *See supra* text accompanying notes 36–37.

A. Certain Legal Principles

- Neither Delaware nor New York law restricts the ability of a corporation to furnish information to its shareholders.
- Both Delaware and New York law specifically grant record holders of shares (and certain beneficial holders) the right to inspect the books and records of the corporation for any purpose reasonably related to their interest as shareholders.[67] While access to documents can be restricted by designating them as confidential, confidential treatment requires justification, which may include harm to the corporation and protecting the personal information of participants in corporate activities.[68]

B. Drafting Considerations

Shareholders agreements should permit only limited disclosure and use of confidential information (e.g., with officers, directors, and advisors of the shareholder and its affiliates in connection with their management of the investment; consider also whether shareholders should be permitted to disclose confidential information to prospective transferees of shares), to protect the confidentiality of such information. In addition, the corporation should not be required to provide any such information that is subject to a third party confidentiality agreement or if disclosure would result in the corporation waiving any privilege, such as the attorney-client privilege. The shareholders agreement could reduce or eliminate information rights as the shareholder's ownership interest declines.

VI. Transfer Restrictions

A. Transfer Restrictions Generally

Shareholders of private companies often want to restrict transfers of shares by other shareholders for a variety of reasons, including a desire to ensure that they "know who they are investing with," to limit the number of shareholders for administrative reasons, and to ensure that competitors or other "undesirable" parties do not become shareholders and thereby gain access to confidential information about the company.

1. Certain Legal Principles:

- *Transfer Restrictions Must Be in Writing*. Both Delaware and New York law permit many types of restrictions on transfers of shares, but in Delaware the restrictions must be in writing, either in the corporation's certificate of incorporation, its bylaws, or in an agreement among shareholders or

67. Del. Code Ann. tit. 8, § 220 (2001 & Supp. 2008); N.Y. Bus. Corp. Law § 624 (McKinney 2003).

68. *See* Del. Code Ann. tit. 8, § 220 (2001 & Supp. 2008); *see also* Amalgamated Bank v. UICI, No. 884-N, 2005 WL 1377432, at *5 (Del. Ch. June 2, 2005).

among shareholders and the corporation.[69] While New York does not explicitly require that transfer restrictions be in writing, the requirement is implied by its case law.[70]

- *Shareholders Must Have Notice of, or Share Certificate Must Reflect, Transfer Restriction.* Section 8-204 of the Uniform Commercial Code (the "U.C.C."), as adopted in both Delaware and New York, provides that a transfer restriction imposed by the corporation, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless the shares are certificated and the restriction is noted conspicuously on the share certificate or the shares are uncertificated and the registered owner has been notified of the restriction.[71] "Knowledge" as defined in the U.C.C. means actual knowledge of the restriction.[72] These requirements are reaffirmed in Del. G.C.L. section 202(a). Failure to follow the required formalities may result in a third-party purchaser acquiring title to the shares free of the transfer restriction.[73]
- *Permissible Types of Transfer Restrictions.* Del. G.C.L. section 202(c) specifically identifies five categories of permitted transfer restrictions:
  - Provisions that obligate a shareholder to offer to the corporation, other shareholders, or any other person a prior opportunity, to be exercised within a reasonable time, to acquire the shares (for example, rights of first refusal, rights of first offer, or tag-along rights, as discussed below);[74]
  - Provisions that obligate the corporation, any shareholder, or other person to purchase shares that are the subject of a purchase and sale agreement concerning those shares (for example, mandatory sale provisions, as discussed below);[75]
  - Provisions that require the corporation or shareholders to consent to any proposed transfer of shares, to approve a proposed transferee, or to approve the amount of shares that any person or group of persons may own;[76]
  - Provisions that obligate a shareholder to sell or transfer shares to the corporation, other shareholders, or any other person, or cause or result in an automatic sale or transfer of shares to any of them;[77] and

69. DEL. CODE ANN. tit. 8, § 202 (2001).

70. *See, e.g.*, Rafe v. Hindin, 288 N.Y.S.2d 662, 663–64 (App. Div.) (restrictive legend on share certificate that reflected the agreement of the parties was a sufficient memorialization of transfer restrictions), *aff'd*, 244 N.E.2d 469 (N.Y. 1968); Murphy v. George Murphy, Inc., 166 N.Y.S.2d 290, 294 (Sup. Ct. 1957) (enforcing a restriction on transfer contained in a contract between shareholders and a corporation).

71. *See* U.C.C. § 8-204 (1994).

72. U.C.C. § 1-202(b) (2008); *see* Agranoff v. Miller, No. 16795, 1999 WL 219650, at *13 (Del. Ch. Apr. 12, 1999) (purchaser "need not have actual, clairvoyant knowledge as to how a court will rule on whether a restriction is viable," only actual knowledge of a potential restriction).

73. *See* U.C.C. § 8-303 (1994); *Agranoff*, 1999 WL 219650, at *12–15.

74. DEL. CODE ANN. tit. 8, § 202(c)(1) (2001).

75. *Id.* § 202(c)(2).

76. *Id.* § 202(c)(3).

77. *Id.* § 202(c)(4).

- Provisions that prohibit the transfer of shares to, or ownership of shares by, designated persons or classes or groups of persons, if such designation is not manifestly unreasonable.[78]

New York does not have a statute that recognizes specified types of transfer restrictions.

- *Restrictions on Transfer Must Serve a "Reasonable" Purpose.* In considering the enforceability of transfer restrictions, the Delaware and New York courts seek to balance the concern that "[a]n important incident of the ownership of property is its transferability . . . [so] a general restraint upon alienation is invalid because contrary to public policy," with a recognition that transfer restrictions may be used to further reasonable corporate purposes.[79]
  - Del. G.C.L. section 202(d) identifies several purposes for transfer restrictions that are conclusively presumed to be reasonable, such as maintaining tax advantages for the corporation or its shareholders, including subchapter "S" corporation elections, preserving net operating losses or other tax attributes, qualifying or maintaining status as a real estate investment trust, maintaining statutory or regulatory advantages, or complying with applicable law.[80] However, this list is not all-inclusive: Del. G.C.L. section 202(e) states that "any other lawful restriction" will be permitted.[81]
  - Under Delaware common law, restrictions on transfer are generally valid if they are "reasonably necessary to advance the corporation's welfare or attain the objectives set forth in the corporation's charter."[82]
  - Since the adoption of Del. G.C.L. section 202 in 1967, "the Delaware courts have been broadly deferential to the decisions of market participants when they decide to place restrictions on [shares]," and have placed the burden of demonstrating that a transfer restriction is unreasonable on the party seeking to contest the restriction.[83]
  - Similarly, under New York law, a restriction on transfer of corporate shares is enforceable if it "effectuates a lawful purpose, is reasonable, and is in accord with public policy."[84]
- *Circumstances in Which Transfer Restrictions May Be Unenforceable.* Analyses of reasonableness are heavily fact dependent. Delaware courts have struck

78. *Id.* § 202(c)(5).

79. *E.g.*, Tracey v. Franklin, 67 A.2d 56, 58 (Del. 1949).

80. Del. Code Ann. tit. 8, § 202(d) (2001).

81. *Id.* § 202(e).

82. Capital Group Cos. v. Armour, No. 422-N, 2005 WL 678564, at *5 (Del. Ch. Mar. 15, 2005); *see also, e.g.*, Grynberg v. Burke, 378 A.2d 139, 143 (Del. Ch. 1977) (restraint on the free transferability of shares is permissible if it "bears some reasonably necessary relation to the best interests of the corporation"), *rev'd on other grounds sub nom.* Oceanic Exploration Co. v. Grynberg, 428 A.2d 1 (Del. 1981).

83. *Capital Group*, 2005 WL 678564, at *8.

84. Benson v. RMJ Sec. Corp., 683 F. Supp. 359, 371 (S.D.N.Y. 1988) (quoting Levey v. Saphier, 388 N.Y.S.2d 644, 645 (App. Div. 1976)).

down transfer restrictions as unreasonable only in limited circumstances in which the transfer restriction at issue was tantamount to an absolute restraint on transfer or when the complaining shareholder did not receive appropriate notice of the restrictions.

- For example, in *Greene v. E.H. Rollins & Sons, Inc.*,[85] a certificate of incorporation granted the corporation the right to purchase, at a formula price, any shares of the corporation that were either transferred without first being offered to the corporation or held by non-employees.[86] The Delaware Court of Chancery noted that the rationale for the provision was "to insure the harmonious conduct of the business and to prevent the introduction of any Common Stockholders for any reason deemed unsuitable," but found no reasonable business purpose for this rationale.[87] The court also pointed out that the provision at issue could be used to prevent all transfers to persons other than the corporation, or could, to the extent transfers to other persons actually occurred, cause the transferee not to have any certainty as to its investment because of the corporation's ability to call the shares for repurchase at any time.[88] The "severe and exacting" nature of the restraint and the inability of the court to "discover any basis on which to rest the view that the imposed restraint [was] reasonable" distinguished the transfer restriction from others that had been upheld by the Delaware courts.[89] However, this case was decided before Del. G.C.L. section 202 was adopted, so the result may be different today.
- In addition, in *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*,[90] the U.S. Court of Appeals, applying Delaware law, found that a corporation's right of first refusal contained in bylaws adopted after a shareholder had acquired its shares was unenforceable against that shareholder because the restriction was broader than reasonably necessary to further a valid corporate purpose, and the shareholder had not received sufficient notice of the restriction to consent to it.[91] Specifically, the right of first refusal was intended to maintain control of the corporation among associated companies, but its price and other terms deviated so markedly from market price and terms that the restriction was held by the court to be broader than necessary to accomplish its objective or to be enforced against the particular shareholder.[92]

85. 2 A.2d 249 (Del. Ch. 1938).
86. *Id.* at 250–51.
87. *Id.* at 252–54.
88. *Id.* at 253.
99. *Id.* at 254.
90. 490 F.2d 818 (5th Cir. 1974).
91. *Id.* at 826–27. The court's holding is consistent with the last sentence of Del. G.C.L. section 202(b), which states that a stock transfer restriction will not be binding with respect to shares issued prior to the adoption of the restriction unless the holder of the shares consents to the restriction on such holder's shares. *See* Del. Code Ann. tit. 8, § 202(b) (2001).
92. *B & H Warehouse*, 490 F.2d at 826–27.

- In New York, as in Delaware, courts apply a reasonableness analysis to transfer restrictions so that they will condemn not "a *restriction* on transfer . . . but an effective *prohibition* against transferability itself."[93] An unreasonable restraint on alienation would include a restriction that would remain in force for an indefinite period of time or would prohibit transfers to anyone other than a specified person. For example, in *Lam v. Li*,[94] the court held that an agreement that granted a shareholder and his successors the right to purchase 50 percent of the shares of the corporation for a fixed price of $10, with no temporal limitation, was unenforceable as an unreasonable restraint on alienation because the option did not have a specified time limit, and "the onerous terms of the option—the $10 purchase price and the percentage of shares involved—effectively prevent[ed] defendant from transferring the shares to anyone but plaintiff."[95]
- Similarly, in *Rafe v. Hindin*,[96] two shareholders, each holding 50 percent of the corporation's shares, included legends on their share certificates that permitted each shareholder to transfer his shares only to the other shareholder, unless the other shareholder consented to a transfer to a third party.[97] The court held that the restrictive legend was void as against public policy because it did not specify a price and enabled either party to withhold consent to a transfer to a third party unreasonably, thereby rendering "the sale of the plaintiff's stock impossible to anyone except to the individual defendant at whatever price he wishes to pay."[98]

- *Provisions Requiring Consent to Share Transfers*. When consent of the corporation or other shareholders is required prior to making a share transfer, such consent must not be unreasonably withheld.[99]

- *Limitations on Corporation's Ability to Exercise Repurchase Rights*. If an agreement gives the corporation a right to repurchase its shares from shareholders, its ability to exercise the right will be subject to state law limitations. For example, a Delaware corporation may not repurchase its own shares if its capital is impaired or if the repurchase will cause its capital to become impaired.[100] A repurchase would impair the corporation's capital if it would

93. Allen v. Biltmore Tissue Corp., 141 N.E.2d 812, 816 (N.Y. 1957) (emphasis added).

94. 635 N.Y.S.2d 26 (App. Div. 1995).

95. *Id.* at 27.

96. 288 N.Y.S.2d 662 (App. Div.), *aff'd*, 244 N.E.2d 469 (N.Y. 1968).

97. *Id.* at 663–64.

98. *Id.* at 666.

99. *See, e.g.*, *id.* (declaring a clause that would require consent to transfer shares as void, unreasonable, and against public policy because it did not prohibit the unreasonable withholding of consent); *see also* Vardanyan v. Close-Up Int'l, Inc., No. CV-06-2243(DGT), 2007 WL 4276670, at *6 (E.D.N.Y. Nov. 30, 2007), *aff'd*, 315 F. App'x 315 (2d Cir. 2009) (upholding restriction on transfer because contractual measures were in place to prohibit unreasonable withholding of consent (e.g., time limitation and requirement to use best efforts)).

100. Del. Code Ann. tit. 8, § 160(a)(1) (2001).

cause the value of the corporation's net assets (i.e., assets minus liabilities) to be less than the aggregate par value of the corporation's shares.[101] Similarly, under New York law, a corporation may not repurchase its shares if the corporation is then insolvent or would thereby be made insolvent, and its shares may be repurchased only out of surplus.[102]

2. Drafting Considerations:

- *Documentation and Notice of Transfer Restrictions.* If the shareholders agreement contains restrictions on transfers of shares, a legend should be included on the share certificates stating that the shares are subject to transfer restrictions contained in the shareholders agreement (or notice should be delivered to any transferee if the shares are uncertificated). The restrictions may (but are not required to) appear also in the certificate of incorporation and/or bylaws, but shareholders should understand that this alone may not provide the required notice of transfer restrictions.
- *Reasonableness of Transfer Restrictions.* Restrictions on transfers of shares should be specific and address legitimate purposes of the corporation. If the corporate purposes are not reasonably apparent, an explanation of the intended purposes—for example, in the recitals to the shareholders agreement—may be helpful. The "reasonableness" of transfer restrictions should be considered in light of the specific facts (and, in the case of a Delaware corporation, the permitted categories of, and purposes for, restrictions on transfer described in Del. G.C.L. section 202(c) and (d)). In particular, restrictions may be subject to challenge if they could last indefinitely, would require a sale without any guidance on pricing, would limit transfers to a single beneficiary, or would permit the beneficiary to determine arbitrarily whether or not to permit a transfer with no requirement that consent cannot be unreasonably withheld.
- *Applicability to Transferees.* The shareholders agreement should make clear whether the transfer restrictions apply only to the original shareholders that are party to the agreement or also to their transferees. Most commonly, the shareholders intend to bind transferees, so the shareholders agreement will provide that it is binding on the parties as well as their successors and assigns. To ensure that transferees have notice of the transfer restrictions contained in the shareholders agreement, the transferees should execute a joinder to confirm that they agree to be bound by the terms of the shareholders agreement.
- *Indirect Transfers.* If desired, the parties may want to ensure that the transfer restrictions will apply to direct as well as indirect transfers of shares.

101. Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 153 (Del. 1997) (citing DEL. CODE ANN. tit. 8, § 154).

102. N.Y. BUS. CORP. LAW § 513(a) (McKinney 2003); Schlaifer v. Kaiser, 377 N.Y.S.2d 356, 360 (Sup. Ct.), *aff'd*, 378 N.Y.S.2d 639 (App. Div. 1975).

For example, if a shareholder is a "shell company" whose sole asset is the shares, the same transfer restrictions that apply to a transfer of shares of the corporation should also apply to a transfer of ownership of the shareholder. If any shareholder (or any transferee of shares) owns other assets, however, the remedy that other shareholders should have in the event of a change of control of the shareholder requires careful consideration. One approach that is favorable to the non-transferring shareholders would be to grant them or the corporation a right to purchase the shares of the corporation upon a change of control of a shareholder, although this may create valuation issues. Another less common form of indirect transfer would be a sale of a derivative, such as a total return swap, in which the economic value of the shares is transferred without altering the legal ownership. Although indirect economic transfer provisions are not uniformly included in shareholders agreements, they may be enforceable under the legal standards discussed above and should be considered carefully when drafting a shareholders agreement.

B. Right of First Refusal/Right of First Offer

Shareholders agreements often include a right of first refusal or right of first offer as a means to ensure that the company and/or other shareholders will have an opportunity to purchase any shares that any shareholders desire to sell. A *right of first refusal* (a "ROFR") requires a shareholder that desires to sell its shares to present an offer made by a potential purchaser that it proposes to accept to the other shareholders and/or the corporation, who then have an opportunity to purchase the shares at the same price and terms. In contrast, a *right of first offer* (a "ROFO") requires the selling shareholder to first solicit offers from the other shareholders and/or the corporation, and if the selling shareholder prefers to seek higher offers from third parties, it may do so, but it may not sell the shares to a third party at a lower price or on other terms that are less favorable to the selling shareholder than those offered by the other shareholders and/or the corporation. In general, a ROFO is considered to be preferable to a selling shareholder because knowledge that the other shareholders and/or the corporation will have a right to match a third-party offer may discourage potential third-party purchasers from doing the work necessary to make an offer.

1. Certain Legal Principles:

- Both Delaware and New York courts have held that ROFRs and ROFOs are enforceable if not unreasonable.[103]

103. *See, e.g.*, Martin v. Graybar Elec. Co., 285 F.2d 619, 625 (7th Cir. 1961) ("The weight of authority is to the effect that a corporate by-law which requires the owner of the [shares] to give the other [shareholders] of the corporation . . . an option to purchase the same at an agreed price or the then-existing book value before offering the [shares] for sale to an outsider, is a valid and reasonable restriction and binding upon the [shareholders]." (citations omitted)); Lawson v. Household Fin. Corp., 147

- Delaware and New York courts apply strict principles of construction to interpret ROFRs narrowly—the court must be able to ascertain the intent of the parties to a reasonable degree of certainty.[104]

2. Drafting Considerations:

- *Share Repurchase Limitations.* If a ROFR or ROFO gives the issuing corporation a right to purchase, the corporation may have insufficient capital at the relevant time to make the purchase. Accordingly, the corporation and shareholders should consider giving the corporation the power to assign its rights or provide that the other shareholders also have ROFR/ROFO rights. If there are multiple beneficiaries of the ROFR/ROFO, the priority and allocation of shares among the beneficiaries should be specified.

- *Form of Consideration Issues.* Typically, a ROFR or ROFO allows a third-party purchaser to purchase the offered shares only on the same terms as, or terms that are no less favorable to the selling shareholder than, the terms offered to the corporation and/or the other shareholders. This requirement raises issues if the offered price includes non-cash consideration such as debt or equity securities of the purchaser. In a ROFO, if a cash offer by the corporation and/or the other shareholders is not accepted by the selling shareholder, must the ROFO be retriggered if the selling shareholder is willing to sell the shares to a third party for non-cash consideration? In either a ROFR or a ROFO, how should non-cash consideration be valued? May the corporation and/or another shareholder offer its own non-cash consideration, or only the cash equivalent? A draftsperson should consider whether to include in the ROFR/ROFO provision the permissible form(s) of consideration, and/or how non-cash consideration will be valued.

- *Disparate Economic Power.* Seemingly neutral provisions such as ROFOs and ROFRs can allow parties to behave "strategically" if they have disparate economic power. For example, if one shareholder has substantial

A. 312, 315 (Del. Ch. 1929) ("Where reasonable restraints founded in considerations which favor the corporate welfare are imposed in favor of the acquisition of a corporation's [shares] by the corporation itself, the authorities hold that such restraints are not offensive to the general policy of the law which favors the freedom of alienation."), *aff'd*, 152 A. 723 (Del. 1930); Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 541 (1957); Penthouse Props. v. 1158 Fifth Ave., Inc., 11 N.Y.S.2d 417, 422 (App. Div. 1939) ("[R]estrictions against the sale of shares of stock, unless other [stockholders] of the corporation have first been accorded an opportunity to buy, are not repugnant to" the general rule that the ownership and the right to alienate cannot be vested in different persons.).

104. *See* Globe Slicing Mach. Co. v. Hasner, 333 F.2d 413, 415–16 (2d Cir. 1964) (corporation's ROFR did not apply to shares transferred to a shareholder's executor upon the shareholder's death because the first-offer provision did not clearly state the corporation's intent to apply it to testamentary transfers); Julian v. E. States Constr. Serv., Inc., No. 1892-VCP, 2008 WL 2673300, at *8–11 (Del. Ch. July 8, 2008) (offering broad construction of ambiguous terms of a shareholders agreement to reflect that the drafters' intent was that only employees who are shareholders may enforce a ROFR).

sources of liquidity (such as a "financial partner") while another does not (such as a "sweat equity partner"), the shareholder with access to liquidity may favor the more restrictive ROFR, while the other shareholder may favor the ROFO. The relative economic interests of the shareholders should be considered when selecting this type of transfer restriction. Similarly, if financing or regulatory approval may be required, a sufficiently long exercise period should be incorporated to ensure that the parties to the shareholders agreement are able to obtain the benefit of the ROFR/ROFO provision.

- *Less than All Offered Shares*. Another issue for the draftsperson is whether ROFR/ROFO rights should be exercisable with respect to less than all of the offered shares. Typically, a corporation and/or shareholders with ROFO/ROFR rights are permitted to exercise the right only if they offer to purchase all of the offered shares, to ensure that the selling shareholder is not left holding a position that is economically too small to sell.
- *Assignability of ROFR/ROFO Rights*. Typically, ROFR/ROFO rights are not assignable. However, the parties should consider whether limited assignability should be permitted. For example, should a shareholder be permitted to assign its rights to an affiliated individual or entity?

C. Mandatory Sale Provisions

A mandatory sale provision may be included in a shareholders agreement as a means of maintaining a limited group of shareholders and/or preserving the continuity of ownership of the business. This type of provision requires a shareholder to sell its shares to the corporation (or to other shareholders) in specified circumstances (usually upon death or disability, retirement, or termination of employment).

1. Certain Legal Principles:

- As discussed above under "Transfer Restrictions Generally," Delaware law specifically allows for a restriction on transfer that would require a shareholder to sell its shares to the corporation or other shareholders.[105] While New York does not have a statute that recognizes specified types of transfer restrictions, New York courts have held that mandatory sale provisions are enforceable, subject to reasonableness tests.[106]
- A disparity between the actual fair market value of the shares at the time of repurchase and a fixed or formula price contained in an agreement granting repurchase rights is usually held not to invalidate the restriction

105. Del. Code Ann. tit. 8, § 202(c)(4) (2001).
106. *See, e.g.*, Benson v. RMJ Sec. Corp., 683 F. Supp. 359, 371 (S.D.N.Y. 1988).

itself.[107] On occasion, courts have adjusted valuations to reflect more accurately the true value of the shares.[108]

- Employee shareholders are often required to transfer their shares to the corporation at the original issuance price upon a termination of their employment. Courts generally respect such provisions, even where there is great disparity between purchase price and true value, because the employee typically has received his or her shares as an incident to employment by the corporation and as an incentive to align his or her interests with those of the corporation.[109]

2. Drafting Considerations:

- The repurchase right or obligation should be required to be exercised within a reasonable time after the occurrence of the triggering circumstance. Shareholders agreements should include clear language about when this right is triggered and anticipate practical obstacles to exercise. For example, in the case of repurchase rights triggered upon the death of a shareholder, the mandatory sale provision should allow sufficient time for the testamentary or probate procedures that would be required before assets of the decedent's estate can be sold.

- The repurchase price is often a key issue in mandatory sale provisions. The repurchase price can be a fixed price, agreed upon at the time the shareholders agreement is entered into, or a price determined later, after the triggering circumstance occurs, by reference to the corporation's book value, a formula or other methodology contained in the shareholders agreement, or by a third-party valuation of the shares.

- The provisions for determining the purchase price must be drafted in detail and with great care. For example, the mandatory sale provision should specify the date at which the shares are to be valued (e.g., the date of the triggering circumstance, the end of the most recently completed fiscal quarter, or some other date), whether deviations from generally accepted accounting principles are permitted in calculating value using a formula based on earnings (and if so, what they are), whether a discount

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107. *See, e.g.*, Allen v. Biltmore Tissue Corp., 141 N.E.2d 812, 816 (N.Y. 1957) (sustaining bylaw provision giving the corporation the right to repurchase shares of a deceased shareholder at the original issuance price). *But see* B & H Warehouse, Inc. v. Atlas Van Lines, Inc., 490 F.2d 818, 826 (5th Cir. 1974) (inadequacy of book value, the fixed price in the agreement, was an important factor in holding the restriction invalid).

108. *See, e.g.*, Aron v. Gillman, 128 N.E.2d 284, 288–89 (N.Y. 1955) (adjusting the book value of the stock to reflect the value of the corporation's inventory and its tax liability); *see also Benson*, 683 F. Supp. at 371 (remaining shareholders might have breached their fiduciary duty when the value of a deceased shareholder's equity was grossly in excess of the amount his estate received from the remaining shareholders pursuant to a forced sale provision).

109. *See, e.g.*, Martin v. Graybar Elec. Co., 285 F.2d 619, 625–27 (7th Cir. 1961) (applying New York law); Gallagher v. Lambert, 549 N.E.2d 136, 137–38 (N.Y. 1989).

for minority ownership, lack of liquidity, or other factors should be applied, and any other matters deemed relevant to the valuation.

- Other terms governing the repurchase should be addressed with specificity. If life or disability insurance is required to be maintained to fund repurchases triggered by death or disability, then appropriate provisions should be included to address the requirement. In the case of a mandatory sale resulting from disability, the definition of "disability" should be clearly defined, and the agreement should identify the person(s) who will make the determination that the shareholder has in fact become disabled. Lastly, due to the frequency of disputes concerning mandatory sale provisions, particularly valuation disputes, the draftsperson should consider whether to include a dispute resolution provision that applies specifically to this provision.

D. Drag-Along Rights

A drag-along provision gives one or more shareholders a right to force other shareholders to sell their shares at the same price and upon the same terms as the shareholder exercising the drag-along right. These provisions may also force sale transactions such as mergers and sales of substantially all of the corporation's assets. A drag-along right can be attractive because it effectively grants shareholders an option to sell a larger stake of the company than they own, and thereby realize a higher sale price, without adhering to certain legal and procedural requirements normally associated with such sales. Prospective acquirers of a corporation also view drag-along rights favorably, as they facilitate the acquisition of all or significant blocks of the corporation's outstanding shares.

1. Certain Legal Principles:

- While Del. G.C.L. section 202(c)(4) specifically permits a restriction on transfer that would require shareholders to sell their shares to the corporation, other shareholders, or any other person, case law concerning the enforceability of drag-along rights is scarce. In one instance, the Delaware Court of Chancery ruled that the terms of a drag-along provision applied to a transaction, although neither party specifically challenged the enforceability of the provision.[110] The court has also mentioned in dicta that a shareholders agreement that would force investors to sell their shares in the event of a merger would be enforceable.[111] No New York court has addressed the enforceability of drag-along rights.

110. *See* Minn. Invco of RSA #7, Inc. v. Midwest Wireless Holdings LLC, 903 A.2d 786, 799 (Del. Ch. 2006) (ruling that majority interest holder's right to "drag along" a minority interest holder in a proposed sale inherently conflicted with the minority holder's ROFR, and that the former right should govern).

111. *See* Shields v. Shields, 498 A.2d 161, 168 (Del. Ch. 1985).

- To the extent that drag-along rights are enforceable, the shareholders exercising these rights may be able to force the other shareholders to sell their shares while sidestepping legal protections, such as appraisal rights, disclosure obligations, and procedural requirements, that would be applicable in the context of a merger. Arguably, the same protections afforded to minority shareholders in a merger, such as appraisal rights, should also be applicable in a drag-along sale. However, Delaware does not recognize the "practical merger" or "de facto merger" doctrine in the same manner as other states, whereby a different form of transaction, such as a sale of substantially all of a corporation's assets, can be viewed as the equivalent of a merger, thereby triggering the statutory protections afforded to mergers.[112]
- Unlike Delaware, New York does recognize the "de facto merger" doctrine,[113] so the statutory protections afforded to mergers could apply to sales pursuant to drag-along rights. On the other hand, New York courts have applied the principles of case law on voting trusts in considering the validity of provisions contained in shareholders agreements.[114] These courts have suggested that statutory protections, such as appraisal rights, may be unavailable in connection with a sale of the company if a shareholder has agreed to a voting trust provision that has this outcome. For example, in *In re Bacon*,[115] the holder of a voting trust certificate sought to exercise statutory appraisal rights after the voting trustees voted in favor of the sale of the assets of the corporation.[116] The New York Court of Appeals commented that "the decisive question . . . is whether the depositor of [shares] under the voting trust agreement has authorized the voting trustees to vote his [shares] and thereby to give consent in his behalf to the proposed sale."[117] Similarly, a minority shareholder can be said to have authorized the sale of a company when it has granted another shareholder drag-along rights in a shareholders agreement.
- Courts generally enforce waivers of appraisal rights when the shareholder waiving such rights is fully informed of all material facts relating to such waiver.[118] Neither New York nor Delaware courts have explicitly ruled whether a waiver of appraisal rights in the context of a drag-along sale

112. *See* Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963); Heilbrunn v. Sun Chem. Corp., 150 A.2d 755, 757 (Del. 1959).

113. *See, e.g.*, AT & S Transp., LLC v. Odyssey Logistics & Tech. Corp., 803 N.Y.S.2d 118, 120 (App. Div. 2005).

114. *See, e.g.*, *In re* Dissolution of Penepent Corp., 750 N.E.2d 47, 50 (N.Y. 2001); Manson v. Curtis, 223 N.Y. 313, 319–20 (1918).

115. 38 N.E.2d 105 (N.Y. 1941).

116. *Id.* at 106–07.

117. *Id.* at 107; *see also In re* Bowman, 414 N.Y.S.2d 951, 953 (Sup. Ct. 1978).

118. *See* Arnold v. Soc'y for Sav. Bancorp, 650 A.2d 1270, 1289 (Del. 1994) (describing the standard for waiver in Delaware).

is enforceable. A waiver of appraisal rights does not preclude, however, a shareholder from bringing an equitable action for breach of fiduciary duty.[119]

2. Drafting Considerations:

- *Specificity*. Because the enforceability of drag-along provisions is uncertain, especially in states such as New York, special care should be taken to draft the provisions with specificity, because a court is more likely to enforce these provisions if it can be shown that minority shareholders clearly consented to the sale process that is being challenged. For example, drag-along provisions should specify the shareholders entitled to exercise the drag-along rights; whether they must have a minimum ownership position at the time of exercise; whether shareholders can be required to sell in a sale of less than 100 percent of the company; whether a drag-along sale requires any minimum triggering price or rate of return; and the time period within which the drag-along right would be exercisable. The drag-along provision should also include specific waivers of appraisal rights and disclosure obligations and require shareholders to vote their shares to approve any matters that must be submitted to shareholders to effect the proposed sale.
- *Other Sale Procedures*. The shareholders agreement should specify whether the shareholders that are being "dragged along" will be obligated to pay their pro rata shares of transaction expenses (at least if the drag-along sale is completed), must make any representations and warranties to the purchaser (e.g., more than representations regarding their title to the shares and authority to sell) in connection with the sale or will be subject to the indemnification obligations, post-closing purchase price adjustments, or other potential liabilities, if any, for which the other selling shareholders, including shareholders selling pursuant to the drag-along right, may be responsible, and whether other procedures will be followed in exercising the rights and implementing the sale process. The drag-along provision should obligate all shareholders to deliver their share certificates, ideally prior to the proposed sale date, with a power of attorney authorizing one shareholder or the corporation to deliver the shares to the purchaser at the closing. As the laws governing the validity of powers of attorney vary from state to state, the person drafting the power of attorney should ensure that it complies with applicable state laws.
- *Multiple Classes of Shares*. Shareholders often desire a right to force a sale of all classes of the company's equity securities, to ensure that the sale can

119. *See, e.g.*, Turner v. Bernstein, 776 A.2d 530, 545 (Del. Ch. 2000) (valid waiver of appraisal rights did not preclude shareholder from bringing a claim of breach of fiduciary duty when the waiver specifically referred only to appraisal rights).

be structured in the way that is most attractive to the purchaser and thus likely to maximize the sale price. When multiple classes of equity securities are subject to a drag-along right, the provisions can become quite complex. In these cases, the obligation to participate "pro rata" among multiple classes with different priorities and the mechanism for ensuring that shareholders sell at the "same price" and on the "same terms and conditions" must be carefully considered and drafted. These issues can be particularly difficult if the aggregate purchase price does not cover the waterfall of the various preferred classes of securities in full and as such there are classes or series of securities that may not be entitled under the waterfall to receive any consideration for their shares. It may also be appropriate to require holders of options and warrants to participate in the sale, without requiring the exercise of the options and/or warrants prior to the closing.

- *Alternative Structures*. Drag-along provisions should be drafted expansively to allow the sale to be consummated not only by a sale of shares but also by means of a merger or sale of substantially all of the corporation's assets (and require the shareholders to vote all of their shares to approve any such transaction and waive any appraisal rights).

E. Tag-Along Rights

Tag-along provisions typically require that shareholders who propose to sell any of their shares offer the other shareholders an opportunity to sell a pro rata portion of their shares to the same purchaser on the same terms and conditions. Typically, a selling shareholder must provide notice of the proposed sale to the other shareholders, who then have a period of time to elect whether to exercise their tag-along rights. Tag-along provisions are generally used to (i) give minority shareholders an opportunity to share in any control premium that may be available if a controlling ownership position is sold and (ii) protect shareholders from being "left behind" when other shareholders are able to realize a liquidity event.

1. Certain Legal Principles:

- *Control Premium*. As a general matter, shareholders who sell a dominant or controlling position should be able to realize a control premium for those shares.[120] A tag-along right effectively forces the controlling shareholder (or group of shareholders selling a control position) to offer the other shareholders an opportunity to share in the control premium.
- *Enforceability*. Tag-along rights are not mentioned in Del. G.C.L. section 202(c), and case law concerning tag-along rights is scarce in both Delaware

120. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1087 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005); Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387, 388 (N.Y. 1979).

and New York. Courts in these states have not ruled on the enforceability of these rights, but they have discussed tag-along rights in various contexts without raising questions regarding their enforceability.[121]

- *Indirect Transfers*. In *Hollinger*, a controlling shareholder granted other shareholders a tag-along right that penalized the controlling shareholder if it sold any shares without ensuring that the purchaser offered the other shareholders an opportunity to sell their shares on the same terms.[122] A minority shareholder claimed that the tag-along provision was triggered by a sale of the controlling shareholder itself by virtue of an implied covenant of good faith and fair dealing.[123] Although the court addressed this issue only through dicta, it described the claim as "facially weak" given the clear wording of the tag-along provision.[124]

2. Drafting Considerations:

- *The Formula to Determine Pro Rata Participation*. Careful consideration should be given to drafting the provision for "pro rata" participation in a tag-along sale. Common variations include:
  - Each shareholder is entitled to sell the same percentage of the total number of shares that it owns, up to the maximum number of shares that the purchaser is willing to purchase, and if any shareholders elect not to participate, either the original selling shareholder may sell additional shares or those shareholders that do elect to participate may sell additional shares (with each shareholder having a right to sell the same percentage of the number of shares that it owns).
  - The selling shareholder will specify a number of shares that it wishes to sell (and that a purchaser is willing to purchase), and each other shareholder will have the right to substitute some of its shares based on a formula that typically follows one of two paradigms: either (a) the tagging shareholder may substitute a number of its shares based on its percentage ownership of the total outstanding shares or (b) the tagging shareholder may substitute a number of its shares based on its percentage ownership of the shares held by all shareholders who will participate in the tag-along sale.

121. *See, e.g.*, Parrott v. Pasadena Capital Corp., No. 96 Civ. 6243 (JFK), 1997 WL 13205, at *4 (S.D.N.Y. Jan. 15, 1997) (monetary award could fully compensate the plaintiff for the loss of his tag-along rights); Seidensticker v. Gasparilla Inn, Inc., No. 2555-CC, 2007 WL 1930428, at *5–6 (Del. Ch. June 19, 2007) (refusing to find a tag-along right when the plain and unambiguous language of a contract did not support such an interpretation); Adams v. Banc of Am. Sec. LLC, No. 602297/04, 2005 WL 1148693, at *7 (N.Y. Sup. Ct. Mar. 31, 2005) (inferring that certain class members' tag-along rights remained enforceable and were not affected by a tortious interference claim).

122. 844 A.2d at 1031–32.

123. *Id.* at 1086.

124. *Id.*

- *Time Periods and Information*. The notice period and information required to be delivered to the other shareholders in connection with a tag-along sale should also be carefully considered. A lengthy notice period or a cumbersome information requirement (e.g., an obligation to deliver the purchase agreement with the notice) can make it difficult to find a purchaser who is willing to comply with these requirements without knowing which shareholders will participate in the sale. Conversely, a brief notice period and more limited information may force the other shareholders to make their sale decisions with inadequate information or analysis. The maximum time period for the completion of the sale is also important because participating shareholders will be unable to sell their shares to another purchaser during this period.

- *Other Sale Procedures*. The shareholders agreement should specify whether the shareholders that are "tagging along" will be obligated to pay their pro rata shares of transaction expenses, must make any representations and warranties to the purchaser (e.g., more than representations regarding their title to the shares and authority to sell) in connection with the sale or will be subject to the indemnification obligations, post-closing purchase price adjustments, or other potential liabilities, if any, for which the other selling shareholders will be responsible, and whether other procedures are to be followed in exercising the rights and implementing the sale process. The provision should obligate all shareholders to deliver their share certificates, ideally prior to the proposed sale date, with a power of attorney authorizing one shareholder or the corporation to deliver the shares to the purchaser at the closing. As the laws governing the validity of powers of attorney vary from state to state, the person drafting the power of attorney should ensure that it complies with applicable state laws.

- *Terms of Sale*. A draftsperson should consider whether differences in the nature of the shareholders may mean that a requirement that all shareholders must participate on the "same terms and conditions" will be difficult to implement in practice. For example, a purchaser may insist upon non-competition provisions from certain shareholders (in particular, members of management), which may not be appropriate (or acceptable) to other shareholders. Similarly, it may not be appropriate to require minority shareholders to make the same representations and warranties to the purchaser that would be given by a controlling shareholder.

- *Substitution of Consideration*. Shareholders should consider whether there are any circumstances in which it would be appropriate for different shareholders to receive different forms of consideration. For example, a purchaser may want to substitute cash consideration for certain shareholders in lieu of the non-cash consideration that it proposes to pay generally, without giving each shareholder a right to receive cash consideration (e.g., if certain selling shareholders are not accredited investors, an issuance of securities of the purchaser to such shareholders may require registration). Alternatively, a selling shareholder may want to insist on cash as consideration for any incremental obligations that it must bear (e.g., if an earn-out is contingent on the continued efforts of that shareholder). In either case, the value of any non-cash consideration should be addressed in the shareholders agreement.

- *Multiple Classes of Shares.* When shareholders holding multiple classes of equity securities are party to a shareholders agreement, the tag-along provisions can become quite complex if a sale of one class (or multiple classes) of shares will give shareholders owning other classes a right to participate in the sale. In these cases, the allocation of rights to participate and the mechanism for ensuring that shareholders sell at the "same price" and on the "same terms and conditions" must be carefully considered and drafted. It may also be appropriate to permit holders of options and warrants to participate in a sale of common shares by another shareholder, ideally without requiring the holder to exercise its options and/or warrants prior to the closing.
- *Permitted Transfers.* The shareholders agreement should allow shareholders to make certain "permitted transfers" (typically to family members or affiliates, or for estate planning purposes) without triggering the tag-along right for other shareholders, so long as the transferee agrees be subject to the tag-along rights. However, such a transfer should not allow a shareholder to circumvent the tag-along right through a two-step process—by transferring the shares to a newly formed affiliate, and then selling the newly formed affiliate to a third party. This can be prevented by requiring the transferee to transfer the shares back to the original shareholder if it ceases to be a "permitted transferee."

VII. Mechanisms for Resolving Deadlock

Dissension among shareholders can lead to deadlock. This is especially true when the board of a corporation is comprised of an even number of directors, and no single shareholder or group of shareholders has the voting power to elect a majority of the directors and effectively control the board. Deadlock can also result in cases where a minority shareholder has bargained for veto rights over significant corporate decisions.

A. Certain Legal Principles—Delaware Law

- The Delaware corporation law statute includes several provisions to address deadlocks. Upon the application of any shareholder of a Delaware corporation, the Court of Chancery may appoint one or more persons as a custodian (and, in case of an insolvent corporation, receiver) of and for the corporation when: "(1) At any meeting held for the election of directors, the stockholders are so divided that they have failed to elect . . . directors . . . ; (2) The business of the corporation is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote for action by the board of directors cannot be obtained and the stockholders are unable to terminate this division; or (3) The corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve, liquidate or distribute its assets."[125] A custodian appointed under Del. G.C.L. section 226 has all the powers of a receiver appointed under Del. G.C.L. section 291, but, with certain exceptions, the authority of the custodian is to continue the business of the corporation and not to liquidate its affairs and distribute its assets.[126]

- As discussed below,[127] New York law provides for dissolution as a remedy for deadlock in certain circumstances. For a Delaware corporation that is not a close corporation, dissolution is not the default remedy for deadlock because dissolution generally requires a board resolution approved by a majority of the directors and either approval of shareholders owning a majority of the outstanding shares or consent in writing of all of the shareholders entitled to vote thereon.[128] However, special dissolution arrangements to address a deadlock, such as tie-breaking votes for directors or stockholders, could be included in a corporation's certificate of incorporation.
- The Delaware statute also includes a narrowly drawn provision that applies only to joint-venture corporations in which two shareholders each own 50 percent of the shares. In this case, unless prohibited by the certificate of incorporation or a shareholders agreement, either shareholder may petition the Court of Chancery to discontinue the joint venture and dispose of the corporation's assets if the shareholders are unable to agree on the desirability of discontinuing the joint venture.[129]

B. Certain Legal Principles—New York Law

- New York's statute expressly addresses the possibility of deadlock in N.Y.B.C.L. section 1104(a), which provides that, unless otherwise indicated in the certificate of incorporation, the holders of shares representing

125. Del. Code Ann. tit. 8, § 226(a) (2001). In deciding whether the "business has been abandoned," courts will make an independent judgment, rather than give business-judgment-rule deference to the board of directors. *See* Giancarlo v. OG Corp., No. 10669, 1989 WL 72022, at *4 (Del. Ch. June 23, 1989). Delaware also authorizes the appointment of a custodian for a deadlocked "close corporation" on two additional grounds. *See* Del. Code Ann. tit. 8, §§ 226(a), 352(a) (2001).

126. *See* Del. Code Ann. tit. 8, § 226(b) (2001).

127. *See infra* text accompanying notes 130–36.

128. Del. Code Ann. tit. 8, § 275 (2001).

129. *Id.* § 273.

50 percent of the votes entitled to be cast in an election of directors may petition for the corporation's dissolution on the grounds: "(1) That the directors are so divided respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained[;] (2) That the shareholders are so divided that the votes required for the election of directors cannot be obtained[;] [or] (3) That there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders.[130] A court may deny the request if it believes the facts do not warrant dissolution.[131] Under New York law, corporate dissolution may not be denied merely because a business has been profitable.[132]

- If a New York corporation's certificate of incorporation requires a supermajority of shareholders to elect directors, or a supermajority of directors for board action, then N.Y.B.C.L. section 1104(b) provides that a petition for dissolution may be brought by the holders of shares representing *more than one-third* of all outstanding shares entitled to vote on non-judicial dissolution under N.Y.B.C.L. section 1001.[133]
- N.Y.B.C.L. section 1104(c) provides that, notwithstanding any provision in the certificate of incorporation, *any* holder of shares entitled to vote at an election of directors may present a petition for dissolution on the ground that the shareholders are so divided that they have failed to elect directors for a period that includes at least two consecutive annual meetings.[134]

- The New York statute also allows a corporation to alter the statutory dissolution requirements by including a dissolution provision in its certificate of incorporation.[135] The existence of such a provision should be noted conspicuously on the face or back of every certificate for shares issued by the corporation.[136]

C. Drafting Considerations

Drafters should discuss with the shareholders whether provisions should be included in the shareholders agreement (or certificate of incorporation) to address the possibility of deadlock, as an alternative to the appointment of a custodian (in the case of a Delaware corporation) or dissolution (in the case of a New York cor-

130. N.Y. Bus. Corp. Law § 1104(a) (McKinney 2003).

131. Wollman v. Littman, 316 N.Y.S.2d 526, 527–28 (App. Div. 1970) (delaying dissolution pending the results of a related breach of fiduciary duty claim).

132. Tavlin v. Munsey Candlelight Corp., 415 N.Y.S.2d 438, 440 (App. Div. 1979).

133. N.Y. Bus. Corp. Law § 1104(b) (McKinney 2003).

134. *Id.* § 1104(c).

135. *Id.* § 1002(a).

136. *See id.* § 1002(c).

poration), particularly in light of the fact that preservation of the corporation as a going concern is usually, but not always, a preferable result for the shareholders.

- *Mandatory Arbitration or Mediation*. One alternative to consider is an arbitration or mediation provision, as arbitration and mediation proceedings can be (but are not always) quicker, less expensive, and more confidential than litigation. New York courts have ordered stays of dissolution proceedings instituted under N.Y.B.C.L. section 1104 pending arbitration of disputes covered by an arbitration agreement.[137]
- *Buy-Sell Arrangements*. Buy-sell arrangements can break a deadlock by eliminating one or more factions of shareholders. This solution preserves the entity as a going concern and is designed to provide a fair price to the shareholder(s) being bought out. One drawback, however, is the risk of manipulation by a shareholder that wishes to squeeze out another shareholder by creating and prolonging a deadlock to trigger the buy-sell provision. As a form of transfer restriction, the existence of a buy-sell provision should be noted conspicuously on the face or back of every certificate of shares issued by the corporation.[138] Shareholders should be aware that the use of a buy-sell provision generally supersedes the right to compel a judicial dissolution of a New York corporation.[139]
- *Voluntary Dissolution Provisions*. Shareholders should consider including special dissolution provisions in the corporation's certificate of incorporation to enable shareholders to force a dissolution in the event of a "deadlock" (in the case of a New York corporation, in more circumstances than those addressed by N.Y.B.C.L. section 1104(a)). The types of "deadlock" that can trigger the dissolution requirement should be carefully considered.
- *Tie-Breaking Vote*. Under recent amendments to Delaware law, the certificate of incorporation can give one director (often the CEO) a tie-breaking vote in the event of a deadlock on a matter that is of fundamental significance to the corporation's ability to conduct its business.[140]

VIII. Preemptive Rights

Preemptive rights give some or all of the shareholders a right to purchase additional shares and/or other types of equity securities that the corporation thereafter proposes to issue.

137. *See, e.g.*, Myers v. Leibel, 107 N.E.2d 512, 512 (N.Y. 1952); Moskowitz v. Surrey Sleep Prods., Inc., 292 N.Y.S.2d 748, 749 (App. Div. 1968).

138. *See* N.Y. U.C.C. Law § 8-204 (McKinney 2005); Del. Code Ann. tit. 6, § 8-204 (2005); *see also* Del. Code Ann. tit. 8, § 202(a) (2001).

139. *See, e.g.*, Johnsen v. ACP Distrib., Inc., 814 N.Y.S.2d 142, 147 (App. Div. 2006).

140. Del. Code Ann. tit. 8, § 141(d) (2001 & Supp. 2008).

A. Certain Legal Principles[141]

- *Delaware Law*. Del. G.C.L. section 102(b)(3) reverses the historic common law presumption that preemptive rights are mandatory, by granting shareholders of a Delaware corporation preemptive rights only if the certificate of incorporation specifically provides for such rights.[142] Preemptive rights of corporations that were in existence on July 3, 1967, remain in effect (even if not provided for in the certificate of incorporation) with respect to all additional issues of shares or convertible securities until such rights are explicitly changed or terminated.[143]

- Delaware courts will enforce preemptive rights agreed to in shareholders agreements or other contracts even when they are not provided in the certificate of incorporation. In *Garza v. TV Answer, Inc.*,[144] the Delaware Court of Chancery interpreted Del. G.C.L. section 102(b)(3) as not eliminating preemptive rights altogether, but as eliminating the common-law rule that shareholders have a preemptive right to subscribe for newly issued shares, while leaving unaltered the ability of a corporation and its shareholders to enter freely into contractual agreements relating to any offering of shares issued in the future.[145]

- Delaware courts have also shown a willingness to interpret broadly the authority of directors to issue shares with preemptive rights. In *Benihana of Tokyo, Inc. v. Benihana, Inc.*,[146] the court held that a board that possessed blank-check authority to issue preferred stock had the power to issue such stock with preemptive rights, despite the fact that the certificate of incorporation specifically denied common law preemptive rights.[147]

- Although the Del. G.C.L. does not specify particular categories of transactions as exempt from preemptive rights, some such categories have been established in Delaware case law.[148]

- *New York Law*. N.Y.B.C.L. section 622(b) provides that shareholders of a New York corporation incorporated on or after February 22, 1998, do not have preemptive rights unless expressly provided for in the articles of

141. Unlike many jurisdictions outside of the United States, most modern corporation statutes in the United States do not impose preemptive rights unless these rights are expressly granted in the certificate of incorporation.

142. Del. Code Ann. tit. 8, § 102(b)(3) (2001).

143. *Id.*

144. No. 12784, 1993 WL 77186 (Del. Ch. Mar. 15, 1993).

145. *Id.* at *3–4.

146. 906 A.2d 114 (Del. 2006).

147. *Id.* at 121.

148. *See, e.g.*, Am. Gen. Corp. v. Cont'l Airlines Corp., No. 8390, 1988 WL 7393, at *8 (Del. Ch. Jan. 26, 1988) (a merger transaction did not violate preemptive rights, notwithstanding the fact that the provision as drafted did not contain this exclusion), *aff'd*, 575 A.2d 1160 (Del. 1990).

incorporation.[149] In the case of corporations incorporated prior to February 22, 1998, preemptive rights do not attach automatically; rather, shareholders retain preemptive rights only if the issuance would adversely affect any unlimited dividend rights or voting rights they possess, unless the certificate of incorporation provides otherwise.[150] The N.Y.B.C.L. also specifically exempts certain types of transactions from express or implied preemptive rights, such as share issuances for consideration other than cash, issuances to effectuate a merger or consolidation, issuances of treasury shares, issuances of options and shares to employees of the corporation, and the sale or option of shares authorized in the certificate of incorporation within two years of incorporation.[151]

- *Remedies*. Few Delaware cases address remedies for the breach of preemptive rights, but a requested cancellation of the shares issued in violation of preemptive rights has been explicitly rejected.[152] In New York, shareholders whose preemptive rights have been violated are entitled to seek an appraisal,[153] and some New York courts have invalidated shares issued in violation of shareholders' preemptive rights.[154]

B. Drafting Considerations

- If preemptive rights for all shareholders are desired, they should be included in the corporation's certificate of incorporation, even if the corporation is party to a shareholders agreement that sets forth the preemptive rights. If only certain shareholders are being granted preemptive rights, their rights can simply be included in a contract.
- Following *Benihana of Tokyo*,[155] if the certificate of incorporation of a Delaware corporation grants the board of directors blank-check authority to issue preferred stock, drafters who wish to prohibit the inclusion of preemptive rights in the terms of the preferred stock should include this limitation on authority in the certificate of incorporation.
- In a corporation with multiple classes of voting shares, the issuance of shares of one class may dilute the voting rights of another. When preemptive rights are granted, the certificate of incorporation or the shareholders agreement should include a clear definition of a shareholder's "pro rata share" and should make explicit whether issuances of shares of certain

149. N.Y. Bus. Corp. Law § 622(b)(1) (McKinney 2003).
150. *Id.* § 622(b)(2).
151. *Id.* § 622(e) (providing full list of statutory exemptions).
152. Superwire.com, Inc. v. Hampton, 805 A.2d 904, 911 (Del. Ch. 2002).
153. Carroll v. Seacroft Plaza, Ltd., 529 N.Y.S.2d 588, 589 (App. Div. 1988).
154. *See, e.g.*, Hyman v. Behar, 241 N.Y.S.2d 625, 626–27 (Sup. Ct. 1963); Tabulating Card Co. v. Leidesdorf, 223 N.Y.S.2d 652, 657–58 (Sup. Ct. 1961).
155. Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 121 (Del. 2006).

classes should trigger preemptive rights for other classes. The definition should be clear as to whether it takes into account the ownership of options, warrants, convertible securities, and other rights to acquire shares and whether the issuance of equity-linked securities triggers preemptive rights or only the issuance of shares upon the exercise of such securities.

- The preemptive rights provisions should address whether a waiver of preemptive rights must be in writing, or whether inaction by the shareholder for a specified time period will be deemed a waiver.

- The preemptive rights provisions should address whether shareholders who have elected to exercise their preemptive rights will also have rights to purchase any shares that will not be purchased by other holders of preemptive rights who have elected not to exercise their rights in full.

- Advance notice requirements, decision periods, and "pro rata share" participation mechanics can cause delay and undue expense for a corporation trying to issue new shares. When drafting a preemptive rights provision, the practical implications of granting preemptive rights should be considered:
  - Exceptions to the preemptive rights provisions, even where already provided for by statute or case law, should be included to avoid the application of preemptive rights when their implementation would be particularly challenging for the corporation (e.g., when securities are issued in the corporation's initial public offering or after the initial public offering, or when securities are issued upon exercise of options, warrants, or convertible securities, when securities are issued as consideration in a business-combination transaction or for other non-cash consideration).
  - In certain circumstances it may be desirable to grant preemptive rights only to a subset of the shareholders or in certain circumstances (e.g., only when shares are issued to an insider or majority shareholder, to avoid exploitation of minority shareholders). It may also be desirable to require certain shareholders (e.g., those with relatively small holdings) to wait to exercise their preemptive rights until after the triggering issuance. This may be particularly useful when a corporation needs to issue shares quickly. Consideration should be given in such situations to the pro rata calculations used to determine each shareholder's right to purchase such shares.
  - The offer and issuance of shares upon exercise of preemptive rights are an offer and a sale of securities requiring either registration under, or exemption from, the Securities Act of 1933 and applicable state securities laws. If any of the shareholders holding preemptive rights are not accredited investors, the issuer must consider whether a registration exemption is available and, if no such exemption exists, the implications of failing to honor the preemptive rights granted to such shareholders.

IX. Amendments and Termination of Shareholders Agreements

A. Certain Legal Principles

- The N.Y.B.C.L. and Del. G.C.L. are silent regarding the minimum consent required to amend or terminate a shareholders agreement.

B. Drafting Considerations—Amendments

- A shareholders agreement should specify the approval requirement for an amendment or waiver of any of its provisions. During the negotiation of the shareholders agreement, the shareholders and their counsel should consider whether amendments of certain provisions should require the approval of all of the shareholders (or at least, the holders of a high percentage of the shares held by all of the shareholders party thereto), whereas other amendments may require a simple majority or lower "supermajority" threshold. Drafters should also consider whether the consent of specified individual shareholders should be required for amendments of provisions that grant special rights to those shareholders (e.g., board nomination rights). Class voting may also be appropriate.
- Ideally, shareholders agreements should clearly identify the level of approval required for amendments. Simply requiring the approval of a shareholder when an amendment would "adversely affect its rights" can create uncertainty as to what approvals for a particular amendment will be required. To avoid this uncertainty, the parties should consider including in the shareholders agreement a list of specific matters for which amendments would trigger supermajority, class, or individual approval rights. Because it is hard to predict in advance all of the possible amendments that may be sought, the shareholder may also want to include a right to approve any other amendment that adversely affects its rights or, at least, that adversely affects its rights relative to other similarly situated shareholders. Again, this formulation can create challenges if there are disagreements among shareholders regarding the application of this standard to a particular amendment. Moreover, notwithstanding a provision in a shareholders agreement that may allow amendments to transfer restrictions, an amendment that would impose transfer restrictions on shares of a Delaware corporation will not be binding against any holders of shares that do not vote in favor of the restriction or against the transferees of such shares.[156]

C. Drafting Considerations—Termination

- While shareholders agreements can be drafted to terminate upon the occurrence of any number of events, the most common triggers are the

156. Del. Code Ann. tit. 8, § 202(b) (2001).

consummation of an initial public offering of the corporation or the acquisition of all the outstanding securities of the corporation by an outside party. If registration rights are in the shareholders agreement, the termination provision should allow for their survival after the initial public offering. Other provisions may survive the initial public offering, but this is less common.

- Shareholders agreements may also selectively terminate with respect to certain shareholders upon the occurrence of specified triggering events, such as when the shareholder's ownership percentage falls below a specified threshold.

X. Governing Law of Shareholders Agreements

A. Certain Legal Principles—Choice-of-Law

- *Selection of Delaware or New York as Governing Law.* Delaware and New York statutes allow parties to a contract involving specified minimum monetary amounts to agree that the contract will be governed by the laws of that State:
  - If a contract involves at least $100,000, the parties to such contract may agree that it will be governed by Delaware law if the parties are subject to the jurisdiction of the Delaware courts and may be served there with legal process.[157]
  - If a contract involves at least $250,000 and it does not relate to personal, family, or housing services, the parties to such contract may agree that the contract will be governed by New York law.[158]

- When determining whether the monetary threshold is met, courts generally analyze the basic consideration inherent in the contract at the time of bargaining.[159] In analyzing such consideration, courts may refer to the basic consideration in each contract containing the clause, the consideration in all connected transactions, or the potential or actual contract damages.[160]

- *Selection of Other States as Governing Law.* Other choice-of-law provisions may be enforced. Delaware requires that the chosen state "bear some material relationship to the transaction."[161] Delaware will not enforce foreign

157. *See* Del. Code Ann. tit. 6, § 2708 (2005).

158. *See* N.Y. Gen. Oblig. Law § 5-1401 (McKinney 2010).

159. *See* Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 Del. J. Corp. L. 999, 1003–04 & n.17 (1994); Cambridge Nutrition A.G. v. Fotheringham, 840 F. Supp. 299, 302 (S.D.N.Y. 1994) (enforcing a New York choice-of-law provision when the amount in controversy was less than the statutory threshold because the underlying agreement had an aggregate value in excess of the threshold).

160. *See* Ribstein, *supra* note 159, at 1003 n.17.

161. Pharmathene, Inc. v. Siga Techs., Inc., No. 2627-VCP, 2008 WL 151855, at *7 (Del. Ch. Jan. 16, 2008).

laws "in a manner repugnant to the public policy of Delaware," but a "mere difference between the laws of two states" will not necessarily justify non-enforcement of the foreign law.[162] In New York, the choice of another state's law is also enforceable, but the chosen law must "bear[ ] a reasonable relationship to the parties or the transaction."[163] New York will not apply foreign laws, however, if they "violate some fundamental principle of justice" and are "truly obnoxious."[164]

- Parties often invoke the following formulation: "This Agreement and any claim, controversy, or dispute arising under or related to this Agreement, shall be construed in accordance with and governed by the laws of the State of [New York] [Delaware] *without regard to conflicts-of-laws principles*."
  - This formulation is intended to ensure that the contractually stipulated substantive law will be applied and enforced, specifically by discouraging the application of the doctrine of renvoi (under which a court would apply the whole law of the foreign jurisdiction, including that jurisdiction's conflicts-of-laws principles, so that the court might in the end apply its own substantive law if the foreign conflicts-of-laws rules so dictate).[165] However, both New York and Delaware courts generally disfavor this doctrine, and therefore the italicized portion of the above formulation is not necessary when selecting the law of either jurisdiction as the governing law.[166]
  - Delaware courts interpret this formulation as a selection of the chosen jurisdiction's substantive law;[167] however, they may continue to apply Delaware law to procedural matters.[168] New York courts uniformly interpret this formulation as a selection of the substantive law of the chosen jurisdiction, although they also may apply a different jurisdiction's law to answer procedural questions.[169]
- *Internal Affairs Doctrine*. Application of the "internal affairs doctrine" may override contractual choice-of-law provisions.
  - Under the internal affairs doctrine, certain matters "peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders" must be governed by the internal laws of

162. J.S. Alberici Constr. Co. v. Mid-West Conveyor Co., 750 A.2d 518, 520 (Del. 2000).

163. Welsbach Elec. Corp. v. Mastec N. Am., Inc., 859 N.E.2d 498, 501 (N.Y. 2006).

164. *Id.* at 501 (quoting Cooney v. Osgood Mach., Inc., 612 N.E.2d 277, 284–85 (N.Y. 1993)).

165. 16 Am. Jur. 2d *Conflict of Laws* § 5 (2009).

166. *See* Cooper v. Ross & Roberts, Inc., 505 A.2d 1305, 1307 n.3 (Del. Super. Ct. 1986); Jean v. Francois, 642 N.Y.S.2d 780, 781 (Sup. Ct. 1996).

167. *See, e.g.*, LHO New Orleans LM, L.P. v. MHI Leasco New Orleans, Inc., No. 05C-04-214 SCD, 2006 WL 1134723, at *3 (Del. Super. Ct. Apr. 11, 2006).

168. *See* Maloney-Refaie v. Bridge at Sch., Inc., 958 A.2d 871, 879 n.16 (Del. Ch. 2008).

169. *See, e.g.*, Cohen v. S.A.C. Capital Advisors, LLC, No. 112479/05, 2006 WL 399766, at *5 (N.Y. Sup. Ct. Jan. 3, 2006).

the corporation's state of incorporation,[170] even if the parties provide generally that the shareholders agreement will be governed by the law of a different state. The doctrine only encompasses those allegations that "could [not] have arisen between two parties with no corporate relationship."[171]

- Both Delaware and New York courts have held that the internal affairs doctrine can apply to disputes regarding agreements among shareholders of a corporation formed in the applicable state, even if the agreement includes a choice-of-law clause to which all disputing parties have agreed.[172] In general, New York's commitment to the internal affairs doctrine is less than Delaware's.[173]

- *Absence of Choice-of-Law Provisions*. If a "choice-of-law" provision is not explicitly included in a shareholders agreement, and the internal affairs doctrine (as described above) does not apply, both New York and Delaware will apply the substantive law of the jurisdiction that has the most "significant contacts" or the most "significant relationship" to the matter in dispute.[174]

- *Non-Contractual Subject Matters*. Under New York law, in order for a choice-of-law provision to apply to a non-contractual claim (e.g., tort), the express language of the provision must be "sufficiently broad" as to encompass the entire relationship between the contracting parties.[175] Delaware courts generally enforce a choice-of-law provision when the non-contractual claim arises out of the contractual relationship of the parties.[176]

B. Certain Legal Principles—Governing Forum

- As a general matter, forum selection clauses that result from arm's-length negotiation by sophisticated parties will be upheld absent "fraud, undue influence, or overweening bargaining power."[177]

170. *In re* Topps Co. S'holders Litig., 924 A.2d 951, 958 (Del. Ch. 2007) (quoting Edgar v. MITE Corp., 457 U.S. 624, 645 (1982)); Hart v. Gen. Motors Corp., 517 N.Y.S.2d 490, 493 (App. Div. 1987) (quoting *Edgar*, 457 U.S. at 645).

171. PTI Enters. (U.S.), Inc. v. Del Monte Foods Co., No. 99 Civ. 3794(BSJ), 2003 WL 22118977, at *18 (S.D.N.Y. Sept. 11, 2003).

172. *See, e.g.*, BBS Norwalk One, Inc. v. Raccolta, 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999), *aff'd*, 205 F.3d 1321 (2d Cir. 2000); Rosenmiller v. Bordes, 607 A.2d 465, 469 (Del. Ch. 1991).

173. *Compare In re* Dohring, 537 N.Y.S.2d 767, 769 (Sup. Ct. 1989) (describing New York's internal affairs doctrine as an issue of "convenience and discretion"), *with* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1113 (Del. 2005) (describing Delaware's internal affairs doctrine as one mandated by constitutional principles).

174. Am. Int'l Group v. Greenberg, 965 A.2d 763, 818 (Del. Ch. 2009); *see, e.g.*, Playtex Family Prods., Inc. v. St. Paul Surplus Lines Ins. Co., 564 A.2d 681, 688 (Del. Super. Ct. 1989); *In re* Allstate Ins. Co., 613 N.E.2d 936, 940 (N.Y. 1993) (using conventional contracts analysis); Auten v. Auten, 124 N.E.2d 99, 102 (N.Y. 1954) (same).

175. *See* Krosk v. Lipsay, 97 F.3d 640, 645 (2d Cir. 1996).

176. *See* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1046–50 (Del. Ch. 2006).

177. M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 12 (1972).

- *Delaware Law*. Although Delaware has no statutory provision akin to N.Y. General Obligations Law section 5-1402 (discussed below[178]), forum selection clauses are nonetheless "prima facie valid."[179] Such clauses will be enforced unless they are "unreasonable under the circumstances,"[180] or when fraud or overreaching is present.[181]
- *New York Law*. New York courts must adjudicate actions that arise under agreements that require New York as its governing law, contain valid forum selection clauses, and pertain to transactions worth at least $1,000,000.[182] Forum selection clauses are "prima facie valid" and will be enforced unless "unreasonable or unjust . . . such that a trial in the contractual forum would be . . . gravely difficult and inconvenient" to the challenging party.[183] Even when the transaction is worth less than $1,000,000, or when the parties have not selected New York law, one can argue that a valid forum selection clause operates as a waiver to objections based on personal jurisdiction or forum non conveniens.[184]
- *Arbitration*. Instead of selecting a particular court to govern disputes, parties sometimes select arbitration as a forum. When doing so, parties will often agree that the rules of a designated governing body, such as the American Arbitration Association or the International Court of Arbitration, will govern the proceeding, and that the proceeding will occur in a particular jurisdiction.[185]
  - When interpreting an arbitration clause to determine whether parties consented to arbitration, Delaware courts presume that "*any doubts* concerning the scope of arbitrable issues should be resolved in favor of arbitration."[186] Courts will dismiss a court action in favor of arbitration, however, only when arbitration is mandated by the agreement, not simply permitted by it.[187]

178. *See infra* text accompanying note 182.

179. Hornberger Mgmt. Co. v. Haws & Tingle Gen. Contractors, Inc., 768 A.2d 983, 987 (Del. Super. Ct. 2000).

180. Aveta, Inc. v. Colon, 942 A.2d 603, 608 n.7 (Del. Ch. 2008); *see, e.g.*, Eisenmann Corp. v. Gen. Motors Corp., No. 99C-07-260-WTQ, 2000 WL 140781, at *8 (Del. Super. Ct. Jan. 28, 2000) (refusing to enforce forum selection clauses in individual contracts where plaintiff's claim related to the failure of General Motors to bundle all contracts).

181. *See Hornberger*, 768 A.2d at 987.

182. *See* N.Y. GEN. OBLIG. LAW § 5-1402 (McKinney 2010).

183. Harry Casper, Inc. v. Pines Assocs., L.P., 861 N.Y.S.2d 820, 821 (App. Div. 2008) (quoting Sterling Nat'l Bank v. E. Shipping Worldwide, Inc., 826 N.Y.S.2d 235, 237 (App. Div. 2006)).

184. *See* Indosuez Int'l Fin. B.V. v. Nat'l Reserve Bank, 774 N.E.2d 696, 701 (N.Y. 2002) (discussing personal jurisdiction); Shah v. Shah, 626 N.Y.S.2d 786, 788–89 (App. Div. 1995) (discussing forum non conveniens); A.C.E. Elevator Co. v. V.J.B. Constr. Corp., 746 N.Y.S.2d 361, 363–65 (Sup. Ct. 2002) (discussing venue).

185. *See, e.g.*, McLaughlin v. McCann, 942 A.2d 616, 619 (Del. Ch. 2008).

186. *Id.* at 621 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985)).

187. *See, e.g.*, Willie Gary LLC v. James & Jackson LLC, No. 1781, 2006 WL 75309, at *9–11 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76 (Del. 2006).

- Before dismissing a matter in favor of arbitration, New York courts will ensure that "the dispute falls clearly within that class of claims which the parties agreed to refer to arbitration."[188] However, courts take a more deferential posture when interpreting broadly worded arbitration clauses.[189] Like Delaware, New York will allow arbitrators to decide questions of arbitrability when the arbitration agreement "*clearly and unmistakably so provide[s]*."[190] However, courts are less deferential to an arbitrator's determination of arbitrability when the arbitration clause contains a carve-out of certain subject matters.[191]
- Federal law as set forth in the Federal Arbitration Act[192] similarly reflects a "national policy favoring arbitration,"[193] based on Commerce Clause jurisprudence to preempt state laws that would otherwise interfere with the intent of parties to arbitrate a dispute.[194]

C. Drafting Considerations

- Shareholders agreements should include a choice-of-law provision. To achieve maximum certainty, the provision should select the law of the state of incorporation of the corporation so that the internal affairs doctrine will not cause a court to deviate from the parties' choice of law. This point is especially relevant if the parties expect disputes surrounding the shareholders agreement to involve questions of fiduciary or corporate law.

- Whichever state's law is selected, the choice-of-law provision should specify the types of claims the parties' choice of law is intended to cover. For example, if the parties intend for their chosen law to apply to tort claims that are related to the shareholders agreement, then the choice-of-law provision should so indicate or the parties take the risk that a court would confine the provision to contractual or fiduciary claims.

- Shareholders agreements should also include a choice-of-forum provision, as well as a waiver of any claim of forum non conveniens relating to the

188. Primavera Labs., Inc. v. Avon Prods., Inc., 747 N.Y.S.2d 16, 17 (App. Div. 2002).

189. *See, e.g.*, State v. Philip Morris Inc., 813 N.Y.S.2d 71, 75 (App. Div. 2006) (finding that the phrase "relating to" evinces an extremely broad scope), *aff'd*, 869 N.E.2d 636 (N.Y. 2007); Hirschfeld Prods., Inc. v. Mirvish, 630 N.Y.S.2d 726, 728 (App. Div. 1995) (inquiring as to whether the "allegations of the complaint bear a reasonable relationship to the subject matter governed by the [broadly worded] arbitration agreement"), *aff'd*, 673 N.E.2d 1232 (N.Y. 1996).

190. Smith Barney Shearson Inc. v. Sacharow, 689 N.E.2d 884, 887 (N.Y. 1997) (quoting AT&T Techs., Inc. v. Commc'ns Workers of Am., 475 U.S. 643, 649 (1986)).

191. *See* Eaton Vance Mgmt. v. ForstmannLeff Assocs., LLC, No. 06 Civ. 1510(WHP), 2006 WL 2331009, at *4 (S.D.N.Y. Aug. 11, 2006).

192. 9 U.S.C. §§ 1–16 (2006).

193. Preston v. Ferrer, 552 U.S. 346, 346 (2008) (citing Southland Corp. v. Keating, 465 U.S. 1, 2 (1984)).

194. *See generally id.* at 360–63 (when two parties agreed to arbitrate all disputes arising out of a contract, the Federal Arbitration Act superseded a California law that would have adjudicated a dispute under that contract in an administrative forum).

selected forum. Forum selection clauses address the "inconvenient forum" objection to proceeding with a lawsuit in a particular jurisdiction. The concern is that this objection can be used for strategic instead of logistical reasons (as it was intended).

  - Forum selection clauses can be highly specific. The parties can, for example, select the state court system to the exclusion of the federal court system. However, courts cannot enforce a selection of federal courts to the exclusion of state courts unless federal subject matter jurisdiction requirements are met. For this reason, a forum selection clause that specifies *either* state or federal courts may result in a state court proceeding.

- Compromises in which the parties agree to one state's laws but another state's forum should be considered carefully. Such a compromise may make it less likely that the forum will respect the parties' choice of law, as a forum may not enforce laws of a foreign state that are against such forum's public policy. Finally, parties face increased uncertainty when courts interpret foreign laws with which they are naturally less familiar.

- Consideration should also be given as to whether a forum selection clause is permissive or exclusive. A permissive forum selection clause will address the "inconvenient forum" objection, while allowing some flexibility to determine the most appropriate forum for a particular dispute; however, it may result in a proceeding in a state that is different from the governing law, creating the issues described above in the immediately preceding bullet point.

- Parties can also select arbitration as a forum for resolution of disputes. An arbitration clause would typically involve an agreement to submit disputes arising under the shareholders agreement to arbitration pursuant to the rules of a selected governing body, such as the American Arbitration Association or the International Chamber of Commerce. In addition, Delaware has recently adopted rules permitting judges of the Delaware Court of Chancery to arbitrate cases.[195]
  - A starting point for drafting an agreement to arbitrate should be the model clause recommended by the governing body in question, which would typically have a broad sweep.
  - Perceived advantages of arbitration are confidentiality, more limited discovery, and somewhat expedited results.
  - Excluding various subjects from arbitration could cause a court to be less deferential when considering whether to compel arbitration of interrelated subjects or whether certain questions should be decided in the first instance by a court or an arbitrator.

195. Del. Ct. Ch. R. 96, 97 & 98.

- In addition to selecting the rules to govern the arbitration, an arbitration provision should specify the selection and number of arbitrators, the venue (the procedural rules of which will govern any court intervention and the availability of provisional remedies in aid of the arbitration, such as attachment and injunctive relief), and can also deal separately with provisional relief, the allocation of costs, consolidation of similar claims, the timing of the award, the content of the award, the availability of relief from the award, and, depending on the parties involved, the language of the arbitration and the nationality of the arbitrators.

XI. Conclusion

The shareholders agreement provisions outlined above are typical but not simple; careful consideration should be given to the legal principles underlying these provisions and the drafting required to effect them. Based on the needs of the shareholders, an agreement may not require each of the above provisions, may require additional provisions, or may be better suited to a governing law other than Delaware or New York. The preferences and objectives of each shareholder and each corporation are unique, and care should be taken in drafting a shareholders agreement to ensure that it comports with the intent of the parties.

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FINDING SAFE HARBOR: CLARIFYING THE LIMITED APPLICATION OF SECTION 144

BY BLAKE ROHRBACHER, JOHN MARK ZEBERKIEWICZ, AND THOMAS A. UEBLER*

ABSTRACT

Section 144 of the General Corporation Law of the State of Delaware was adopted for a limited purpose: to rescue certain transactions, those in which the directors and officers of a corporation have an interest, from per se voidability under the common law. That is all. Under its plain language, section 144 plays no part in validating transactions or in ensuring the business judgment rule's application. Over time, however, practitioners and courts have suggested a broader role for section 144, linking the statute to the common-law analysis of interested transactions. This article reviews the history of section 144, the language of the statute, and evidence of its overextension in judicial opinions, closing with a possible statutory revision to make clear the original intent of section 144's drafters.

Ultimately, this article attempts to clarify section 144's limited role and application by distinguishing the analysis under section 144 from the analysis under the courts' common-law fiduciary analysis. Every interested transaction is subject to review under the common law of breach of fiduciary duty. Section 144 merely determines whether the interested transaction will also be subject to the common law of voidability. Conflicts between judicial glosses on section 144 and the text of the statute itself suggest that practitioners should be aware of these principles and recognize that section 144 may provide less protection than they think it does.

I. INTRODUCTION

Section 144[1] was adopted in 1967 as part of the wholesale revision of the General Corporation Law of the State of Delaware (DGCL). By its own terms, section 144 deals with a specific sliver of transactions in which the

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[1]DEL. CODE ANN. tit. 8, § 144 (2006).

directors and officers of a corporation have an interest. Its stated purpose is to rescue those transactions from per se voidability if they qualify for safe-harbor protection under the statute. That is, section 144 does not validate those transactions; it merely prevents them from being invalidated due solely to any director's or officer's interest.

Over time, section 144 has been mentioned in circumstances far outside its intended application. That is, some practitioners and courts have suggested a broader role for section 144—either mentioning section 144 while performing an analysis under the common law or suggesting that compliance with section 144 does more than it actually does. The likely explanation for this unwarranted extension is that section 144 seems somehow linked to the common law because the three tests in section 144 (disinterested director approval, stockholder ratification, and fairness) were derived from the common law and share some features with the common-law tests.[2]

This article tries to clarify the original intent and limited application of section 144 by examining section 144's position in relation to the common-law analysis of interested transactions. We briefly retrace section 144's history and purpose, relying on contemporaneous accounts of the DGCL revision. We then parse the language of section 144 to demonstrate how and when it applies. Finally, we examine evidence of section 144's over-extension in opinions of the Delaware courts.

The basic construct of our thesis is that section 144, by design, has a limited purpose and application. With regard to the subset of interested transactions that it potentially covers, section 144's role can be summed up in a single sentence: it allows the courts to determine whether to analyze an interested transaction exclusively under the common law of breach of fiduciary duty or under both the common law of voidability *and* the common law of breach of fiduciary duty. Compliance with section 144 only removes the specter of voidability from an interested transaction covered by its terms, and it leaves to the common law the determination whether the transaction, now

[2] *Cf.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 365 (Del. 1993) ("Enacted in 1967, section 144(a) *codified judicially acknowledged principles of corporate governance* to provide a limited safe harbor for corporate boards to prevent director conflicts of interest from voiding corporate action.") (emphasis added), *modified*, 636 A.2d 959 (Del. 1994). Of course, even if section 144 codified the business judgment rule, or some form of it, the statute is self-limiting. That is, it applies only to ensure that no interested-director transaction "shall be void or voidable solely for this reason." DEL. CODE ANN. tit. 8, § 144(a) (2006). Regardless of whether section 144 was born out of the common-law business judgment rule, section 144 does not apply the common-law fiduciary-duty analysis by its own terms. It is also important to note that section 144 was modeled in part on charter and bylaw provisions designed to vary the common-law rules relating to voidability of interested transactions. *See infra* note 21.

protected from being found void solely as a result of the offending interest, is otherwise invalid or leads to liability.

Put differently, if a transaction complies with the section 144 safe harbor, it will not be invalidated solely on the grounds of the offending interest, but will be analyzed under the common law regarding breach of fiduciary duty. Section 144 will then have nothing more to do with the transaction. If, by contrast, the transaction fails to comply with section 144, it will be analyzed under both the common law regarding voidability and the common law regarding breach of fiduciary duty.

The Delaware Supreme Court explicated the original purpose of section 144 in *Fliegler v. Lawrence* back in 1976.[3] The defendants in *Fliegler* attempted to use a stockholder ratification complying with section 144(a)(2) to escape a common-law fairness analysis, but the court denied their attempt.[4] "We do not read the statute as providing the broad immunity for which defendants contend. It merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved."[5] The court set forth in clear words the limited application of section 144: "Nothing in the statute . . . removes the transaction from judicial scrutiny."[6]

The Delaware Court of Chancery did something similar in its 2005 *Benihana* decision.[7] The court found that the "Board's approval of the [challenged] [t]ransaction meets the requirements of [section] 144(a)(1)," noting that the "section merely protects against invalidation of a transaction 'solely' because it is an interested one."[8] The defendants in *Benihana* took the position that, "if they meet the requirements of [section] 144(a)(1), the transaction is beyond the reach of entire fairness"[9]—a common misconception. The court stated "[t]hat is not necessarily correct," reiterating that "[s]atisfying the requirements of [section] 144 only means that the [challenged] [t]ransaction is not void or voidable *solely* because of the conflict of interest."[10] Thus, the court noted, "[E]quitable common law rules requiring the

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[3]361 A.2d 218, 221-22 (Del. 1976).

[4]*Id.*

[5]*Id.* at 222.

[6]*Id.*

[7]Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 174-75 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006).

[8]*Id.* at 185 (citing HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 114 n.24 (Del. Ch. 1999)).

[9]*Id.*

[10]*Id.*

application of the entire fairness standard on grounds other than a director's interest still apply."[11]

The lawyers' attempts to broaden section 144's reach in *Fliegler* and *Benihana* are understandable, and quite within their role as "zealous advocate[s]."[12] Unfortunately, certain statements in opinions of Delaware courts may lead the unwary to believe that, for example, compliance with section 144, standing alone, shields a transaction from entire-fairness review. We believe that the time has come for the Delaware courts to reiterate the limited application of section 144 and to make clear to all what section 144 does and does not accomplish.

II. THE HISTORY AND PURPOSE OF SECTION 144

Before section 144 was enacted, a contract or transaction in which a majority of voting directors or officers had an interest was generally presumed to be voidable.[13] This presumption was based in part on the notion that directors having an interest in a contract or transaction were incapable of

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[11]*Benihana*, 891 A.2d at 185.

[12]DEL. LAWYERS' R. OF PROF'L CONDUCT pmbl. § 8 (2008), *available at* http://courts.delaware.gov/Rules (follow "Delaware Lawyers' Rules of Professional Conduct" hyperlink).

[13]*See* Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652, 655 (Del. 1952) ("The interested character of the directors who voted for the stock option plan makes their action voidable only and thus subject to stockholders' ratification."); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938) ("The resolution of November 15, 1924, whereby Sanitary agreed to pay to Consolidated monthly management fees, adopted by a Board of Directors of which the appellants were a majority, was at the least a voidable transaction. In the first place, the votes of the appellants could not be counted in making up a majority of the Board. In the second place, dealing as they did with another corporation of which they were sole directors and officers, they assumed the burden of showing the entire fairness of the transaction. This burden they signally failed to maintain.") (citations omitted); Lofland v. Cahall, 118 A. 1, 8 (Del. 1922) (relying heavily on the fact that there was no one who acted objectively on behalf of the company when holding a transaction voidable), *aff'g* 114 A. 224 (Del. Ch. 1921). The *Potter* court states:

> That two corporations have a majority or even the whole membership of their boards of directors in common does not necessarily render transactions between them void; but transactions resulting from the agency of officers or directors acting at the same time for both must be deemed presumptively fraudulent, unless expressly authorized or ratified by the stockholders; and certainly, where the circumstances show . . . that the transaction would be of great advantage to one corporation at the expense of the other, especially where, in addition to this, the personal interests of the directors, or any of them, would be enhanced at the expense of the stockholders, the transaction is voidable by the stockholders within a reasonable time after discovery of the fraud.

Potter v. Sanitary Co. of Am., 194 A. 87, 91 (Del. Ch. 1937) (internal quotation marks omitted).

voting on its approval. In its 1948 *Blish*[14] opinion, for example, the Delaware Supreme Court stated the general rule to be that "where the Board meets to consider a proposition in which one of its members is personally interested, the interested Director loses pro hac vice his character as a Director and he cannot be counted for quorum purposes."[15] With no quorum, the board cannot duly authorize a transaction, and the transaction may be declared void.[16]

Similarly, in its 1952 *Kerbs* opinion,[17] the Delaware Supreme Court found that, because a profit-sharing plan was approved by only three disinterested directors on an eight-person board, "the plan failed to receive a legal majority of the directors' votes in its favor."[18] In this regard, the court stated: "It is the general rule that the votes of interested directors of a corporation will not be counted in determining whether proposed action has received the affirmative vote of a majority of the Board of Directors."[19] Thus, the question was one of due authorization and, under the common law, transactions that were not properly authorized could be declared void.[20]

It was to this line of cases—and to the draconian result of declaring void an otherwise fair transaction due solely to the fact that it was approved by interested directors—that Professor Folk pointed when describing the ameliorative effect of section 144.[21] Indeed, Professor Folk evidently believed

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[14]Blish v. Thompson Automatic Arms Corp., 64 A.2d 581 (Del. 1948).

[15]*Id.* at 602-03 ("Therefore, if during the course of a meeting a matter arises involving a Director's personal interest, a new count of those present should be had to determine whether or not a quorum exists without the interested Director.").

[16]*See, e.g.*, Belle Isle Corp. v. MacBean, 49 A.2d 5, 9 (Del. Ch.), *aff'd sub nom.* Belle Isle Corp. v. Corcoran, 49 A.2d 1 (Del. 1946).

[17]Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652 (Del. 1952).

[18]*Id.* at 658. After section 144's adoption, the court in *Marciano v. Nakash*, when discussing the *Kerbs* holding stated, "The [*Kerbs*] court concluded that the profit sharing plan was voidable based on the common law rule that the vote of an interested director will not be counted in determining whether the challenged action received the affirmative vote of a majority of the board of directors." Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987) (citing *Kerbs*, 90 A.2d at 658); Bovay v. H. M. Byllesby & Co., 38 A.2d 808 (Del. 1944).

[19]*Kerbs*, 90 A.2d at 658.

[20]*Cf., e.g.*, Hannigan v. Italo Petroleum Corp. of Am., 47 A.2d 169, 171-73 (Del. 1945).

[21]ERNEST L. FOLK, III, REVIEW OF THE DELAWARE GENERAL CORPORATION LAW 67 (1967). As Professor Folk noted: "The need for loosening the traditional common law restrictions on interested director transactions has been recognized in decisions validating by-laws varying the common law rules. These more flexible procedures clearly 'fill a legitimate need in the efficient functioning of the corporate enterprise.'" *Id.* (citations omitted). Section 144 was drafted partly to replace these bylaw (and charter) provisions. *Id.* ("A Delaware statute [in the form Professor Folk proposed] would in part codify decisional law, [and] in part replace by-law and charter provisions . . . ."). *Id.* Several examples of such pre-1967 bylaw or charter provisions appear in the case law. *See, e.g.*, Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 117 n.3 (Del. 1952); Lipkin v. Jacoby, 202 A.2d 572, 573-74 (Del. Ch. 1964); Gottlieb v. McKee, 107 A.2d 240, 242-43 (Del. Ch. 1954); Kaufman v. Shoenberg, 91 A.2d 786, 791 (Del. Ch. 1952); Martin Found., Inc. v. N. Am. Rayon

that "the certainty of a clear statutory rule should deter many unwarranted challenges to bona fide interested director transactions."[22] The purpose of section 144 was clear from the outset: "Section 144(a) is negative in effect. A contract or transaction covered by the statute is not void or voidable *solely* because those approving a transaction have a conflict of interest . . . . *The validating effect does not go beyond removing the spectre of voidability* . . . ."[23]

In their 1967 article discussing the revisions to the DGCL, S. Samuel Arsht and Walter K. Stapleton[24]—both of whom were involved in the DGCL drafting process—described the tight but distinct relationship between section 144 and the common law.[25] Arsht and Stapleton first reiterated the limited purpose of section 144, stating that the statute "specifies three situations in which the fact that an interested officer or director participated in authorizing the transaction will not affect the transaction's validity."[26] Noting that section 144 was merely a safe harbor, designed to remove the specter of *invalidity* of an interested transaction, they made clear that it did not play any role in ensuring the *validity* of such a transaction: "the effect of the statute is not necessarily to validate the transaction but simply to put it on the same footing as any other corporate transaction."[27] That is, once section 144 performs its function, the transaction is in the realm of the common law regarding breach of fiduciary duty, and the courts will apply the common law to determine the effect of that transaction and any remedies stemming from it (among others, liability or an injunction).[28]

Corp., 68 A.2d 313, 314 (Del. Ch. 1949).

[22]FOLK, *supra* note 21, at 67.

[23]ERNEST L. FOLK, III, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 82 (1972) (second emphasis added).

[24]The Honorable Walter K. Stapleton is now a senior judge on the U.S. Court of Appeals for the Third Circuit.

[25]S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75 (1967).

[26]*Id.* at 81.

[27]*Id.* at 82.

[28]What Arsht and Stapleton left unsaid, however, is the effect of subsection (a)(3)—the fairness inquiry. The common law and section 144 (each with a fairness standard but operating in their own spheres) seem to overlap where an interested transaction's fairness would both place the transaction within the section 144 safe harbor and allow the directors to overcome stockholder challenge to the validity of the transaction under a common-law entire-fairness inquiry. As we set forth below, the fairness determination, while virtually identical for both analyses, bears different consequences depending on whether the analysis is statutory under section 144(a)(3) or common law under entire fairness.

III. THE APPLICATION OF SECTION 144

The plain text of section 144 demonstrates its limited role in determining which common-law regime applies to interested transactions. Currently, section 144 provides:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
>
> > (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
> >
> > (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
> >
> > (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.
>
> (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board

of directors or of a committee which authorizes the contract or transaction.[29]

Thus, section 144 does not apply to all potentially "interested" officer or director transactions—merely the limited subset of transactions identified in section 144(a)'s first paragraph (all such contracts or transactions are described in this article as "covered transactions," and the interest of the officer or director identified in the first paragraph of section 144(a) is sometimes referred to as the "offending interest"). The first leg of that paragraph addresses contracts or transactions between the corporation and one or more of its directors or officers. The second leg covers contracts or transactions between the corporation, on the one hand, and another enterprise in which the corporation's officers or directors are officers or directors or have a financial interest, on the other hand.

A "classic" self-dealing transaction between a corporation and one or more of its officers or directors would fall within the ambit of section 144—such as a company's decision to sell some of its assets to the chief executive officer (CEO) or a board's decision to award themselves stock options. Other transactions that might, at first blush, appear to be covered transactions may, upon closer scrutiny, be outside the scope of section 144. These kinds of transactions generally involve the "second leg" of section 144, particularly the portion addressing the "financial interest" of a director or officer in the corporation's counterparty. For example, a transaction between the corporation's CEO and the corporation's wholly owned subsidiary, in which the CEO leases to the subsidiary office space in a building she owns, would not fall under section 144, so long as the CEO is not an officer or director of, and has no financial interest in, the subsidiary.

In addition, if an officer's or director's self-interest arises solely as an anticipated result of a transaction, that transaction may not necessarily be a covered transaction under section 144. For example, where a director approves a merger between the corporation and a third-party bidder with the hope (which may or may not be reasonable) that the third-party bidder will name the director as the CEO of the surviving corporation (with commensurate compensation), section 144 would not apply unless the director were found to have a "financial interest" in the acquiring company.[30]

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[29] DEL. CODE ANN. tit. 8, § 144 (2006).

[30] *Cf.* Litle v. Waters, No. 12,155, 1992 Del. Ch. LEXIS 25, at *12-14 (Del. Ch. Feb. 10, 1992), *reprinted in* 18 DEL. J. CORP. L. 315, 323-24 (1993) (holding that a board's refusal to pay cash dividends was subject to entire-fairness review where the board was motivated to refrain from action based on personal financial interests to the detriment of plaintiff). By contrast, if the

Once the determination has been made that a contract or transaction is a covered transaction, the party seeking the benefit of the section 144 safe harbor must demonstrate compliance with one of section 144(a)'s three provisions. We review each of these provisions in detail.

A. *Section 144(a)(1)—Approval of Disinterested Directors*

A covered transaction may qualify for the section 144 safe harbor if it is approved by a "majority of the disinterested directors," acting in good faith and on an informed basis.[31] Thus, any determination whether a covered transaction qualifies for safe-harbor protection under section 144(a)(1) involves inquiries into the following three factors: (1) whether the approving directors were interested, (2) whether the disinterested directors were acting in good faith, and (3) whether the conflict or relationship of the interested directors or officers was fully disclosed to the disinterested directors.

1. Interest

A director will generally be found to be "interested"—and thus not a "disinterested director" under section 144(a)(1)—if he or she stands on both sides of the transaction or has a personal stake in the transaction that is not shared by the stockholders generally.[32] Financial interest, motives of entrenchment, fraud on the corporation or board, abdication of directorial duty, or sale of a director's vote all tend to show interestedness.[33] A director's significant stock ownership interest, however, does not create a disabling interest "unless the director somehow contrives to favor his own interests over those of other stockholders."[34] As the Delaware Supreme Court noted in *Cede & Co. v. Technicolor, Inc.*, "[A] director who receives a substantial benefit

corporation enters into a merger agreement with a third party, and the agreement requires the corporation's inside directors to "roll over" their shares of the corporation into the purchaser in connection with a reverse triangular merger (i.e., immediately before the merger is effective, the inside directors surrender their shares of the corporation's stock in exchange for shares of the entity that, after the merger is effective, owns and controls the surviving entity), that arrangement could be a covered transaction, since the merger agreement would be a contract between the corporation, on the one hand, and another enterprise (i.e., the buyer) in which the directors of the corporation, by virtue of their agreement to roll over their shares of the corporation's stock into the buyer, have a "financial interest," on the other hand.

[31] DEL. CODE ANN. tit. 8, § 144(a)(1) (2006).

[32] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 & n.13 (Del. 2000).

[33] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993), *modified*, 638 A.2d 956 (Del. 1994); Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 & n.13 (Del. 2000).

[34] Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991).

from supporting a transaction cannot be objectively viewed as disinterested or independent."[35] In considering directorial interest, the courts have applied a different standard to transactions involving "classic self-dealing" (i.e., those in which the director stands on both sides of the transaction) than to those in which the director's alleged interest arises by virtue of some special benefit the director receives as a result of the transaction. In the former case, the section 144(a)(1) analysis is simple—the director is not disinterested.[36] In the latter case, however, the analysis of the alleged interest is far more nuanced.[37] In *Cinerama, Inc. v. Technicolor, Inc.*,[38] the Delaware Supreme Court, in the course of discussing section 144 (which it ultimately found was not applicable to the contested actions), suggested that a "subjective materiality" standard

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[35]*Cede & Co.*, 634 A.2d at 362.

[36]*See* Beneville v. York, 769 A.2d 80, 84 (Del. Ch. 2000).

> Although the defendants do not concede York's interest, their argument that he is disinterested is at odds with the plain language of [section] 144 and with settled case law. The Marketing Agreement was between CARNET, a company that York served as a CEO and director, and SYNERGY, a "corporation . . . in which [York, was a] director[] . . . [and] ha[d] a financial interest . . ." Thus York had a classic self-dealing interest in the Marketing Agreement. This suffices to render him interested and disabled from impartially considering a demand.

Id. (alterations and omissions in original) (footnote omitted). While there are arguments for importing a materiality standard into section 144, the plain text of the statute does not contain one. *See* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 887 & n.20 (Del. Ch. 1999).

[37]Guttman v. Huang, 823 A.2d 492, 502 & n.19 (Del. Ch. 2003).

> I reject this attempt to extend concepts designed to fit classic self-dealing transactions into another context that is quite different. In a typical derivative suit involving a transaction between a director and her corporation, that director is interested because she is on the other side of the transaction from the corporation and faces liability if the entire fairness standard applies, regardless of her subjective good faith, so long as she cannot prove that the transaction was fair to the corporation. In those circumstances, the director has always been considered "interested"[, *see, e.g.*, DEL. CODE ANN. tit. 8, § 144(a),] and it displays common sense for the law to consider that director unable to consider a demand to set aside the transaction between the corporation and herself.
>
> In this case, the plaintiffs attack a myriad of stock sales, not between the defendant-directors and NVIDIA, but between the defendant-directors and marketplace buyers. As a matter of course, corporate insiders sell company stock and such sales, in themselves, are not quite as suspect as a self-dealing transaction in which the buyer and seller can be viewed as sitting at both sides of the negotiating table. Although insider sales are (rightly) policed by powerful forces—including the criminal laws—to prevent insiders from unfairly defrauding outsiders by trading on non-public information, it is unwise to formulate a common law rule that makes a director "interested" whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information.

Id. (footnote omitted).

[38]663 A.2d 1156 (Del. 1995).

would apply to the determination of director interest—i.e., the director "had 'some special characteristic that [made] him . . . especially susceptible to or immune to opportunities for self-enrichment or . . . evidence that [he] in fact behaved differently in this instance than one would expect a reasonable person in the same or similar circumstances to act.'"[39] The Delaware Court of Chancery, however, subsequently explained that *Cinerama*'s materiality standard does not apply to an analysis of director interest under section 144(a)(1), although the court did note that "[t]here is analytic force to the argument that [section] 144 should, like many statutes, be read as incorporating a 'materiality' element."[40]

2. Good Faith

The party seeking protection under section 144(a)(1) must demonstrate that the disinterested directors who approved a covered transaction acted "in good faith." Although the concept of good faith has seldom been addressed in the context of section 144(a)(1), the Delaware Court of Chancery's 2005 *Disney* opinion suggested that the disinterested directors would satisfy the "good-faith" component of section 144(a)(1) if, when considering the transaction, they were "mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies."[41] "On the other hand," the court noted,

> where the evidence shows that a majority of the independent directors were aware of the conflict and all material facts, . . . but acted to reward a colleague rather than for the benefit of the shareholders, the Court will find that the directors failed to act in good faith and, thus, that the transaction is voidable.[42]

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[39] *Id.* at 1167 (first alteration and omissions in original). For example, a payment of $25,000 might not affect the judgment of Bill Gates or Warren Buffett, though it may affect the judgment of the typical American wage-earner.

[40] *Huizenga*, 751 A.2d at 887 n.20. The court suggested that, even if section 144(a)(1) were construed to include a test for "materiality," such a test should not be confused with *Cinerama*'s "materiality" test to determine whether directors are interested in a "transaction to which [section] 144 does not apply." *Id.*

[41] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 756 n.464 (Del. Ch. 2005).

[42] *Id.*

Thus, the *Disney* court construed the "good-faith" component of section 144(a)(1) to require an examination of the subjective motivations underlying the disinterested directors' approval of the transaction.[43]

3. Informed Decision

Finally, section 144(a)(1) requires that the decision of the disinterested directors, with regard to the covered transaction, be made on an informed basis. In *Kosseff v. Ciocia*,[44] the court of chancery described this as requiring that each disinterested director "be informed of the interested nature of the transaction [and] that each be informed of the facts material to the interests of the corporation regarding the transaction (that is, that each employ due care)."[45] Thus, the determination as to whether the directors acted on an informed basis for purposes of section 144(a)(1) requires demonstrating not only that the disinterested directors were advised of the conflict, but also that the directors exercised their fiduciary duty of due care.[46] In *Smith v. Van Gorkom*,[47] the Delaware Supreme Court explained this as the duty "to act in an informed and deliberate manner in determining whether to approve [a transaction] before submitting [it] to the stockholders."[48] The appropriate test under section 144(a)(1) is, therefore, whether the disinterested directors were adequately apprised of the material facts regarding the nature of the potentially

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[43]The Delaware Supreme Court's opinion in *Disney* elaborated on the concept of good faith, generally accepting the court of chancery's definition of "bad faith"—"intentional dereliction of duty, a conscious disregard for one's responsibilities"—as legally correct. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006).

[44]No. 188-N, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006).

[45]*Id.* at *7.

[46]*See also Disney*, 907 A.2d at 756 n.464.

> Under [section] 144(a), a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: 1) the approving directors were aware of the conflict inherent in the transaction; 2) the approving directors were aware of all facts material to the transaction; and 3) the approving directors acted in good faith. In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith).

Id.

[47]488 A.2d 858 (Del. 1985).

[48]*Id.* at 873.

disabling conflict *and* availed themselves of all reasonably available material information concerning the contract or transaction at issue.[49]

B. *Section 144(a)(2)—Approval of Stockholders*

A covered transaction may qualify for the section 144 safe harbor if it is approved by a majority of the stockholders entitled to vote on it, acting in good faith and on an informed basis. Notably, section 144(a)(2) does not, by its terms, require that the stockholder vote be that of the disinterested stockholders,[50] though some cases have described section 144(a)(2) as requiring just that.[51] For example, in *Solomon v. Armstrong*,[52] the Delaware Court of Chancery stated that, in the section 144(a)(2) context, "the [*Disney*] Court reaffirmed the settled proposition that shareholder ratification by a majority of the disinterested shareholders acts as a safe harbor in situations where directors' potentially conflicting self-interests are at issue."[53]

Although these cases do not describe the statutory basis for imposing the "disinterested stockholder approval" requirement, one may posit that the cases imposing that requirement were actually applying section 144(a)(2)'s "good-faith" requirement. That is, where a court references the vote of a "disinterested majority" approving a transaction under section 144(a)(2), the court may have presumed that the interested director or officer, in his or her capacity as a stockholder, was unable in good faith to consider the contract or transaction due to his or her conflicted interest. This interpretation is consistent with the contemporaneous gloss on the stockholder-approval requirement in section 144(a)(2), insofar as interested stockholders' votes will not be invalid per se, but they may be invalidated by a showing of bad faith.

The Folk Report, for example, states, "It is doubtful whether a disinterested shareholder requirement, would be worth the administrative difficulties it would entail. Once again, the 'good faith' requirement should

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[49] *See id.* at 872.

[50] *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005) ("By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve.").

[51] *See In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1205 n.8 (Del. Ch. 1995) ("Under [section] 144(a)(1), a ratifying disinterested director vote has the same procedural effect as a ratifying disinterested shareholder vote under [section] 144(a)(2)."); *see also* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (stating that "approval by . . . disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste").

[52] 747 A.2d 1098 (Del. Ch. 1999).

[53] *Id.* at 1115.

sufficiently guard against abuse."[54] Additionally, Professor Folk's 1972 analysis of the DGCL stated:

> One area of doubt grows out of the fact that some prior decisions appeared to require [stockholder] ratification to be voted by "disinterested" or "independent" stockholders. Such cases apparently regarded stockholders as "independent" if they "were not, on the record, controlled by the directors." Another case discounted ratification because of "the possible indifference, or sympathy with the directors, of a majority of the stockholders," and it was accordingly concluded that ratification of a stock option plan could not furnish the necessary requisite of "good faith exercise of business judgment by directors in dealing with corporate assets." . . . Despite this uncertainty and confusion, [section] 144(a)(2) is quite clear: stockholder ratification conforming to the disclosure and good faith requirements of the statute should effectively uphold an interested-director transaction. The statute does not require that the ratifying stockholders be "disinterested" or "independent," nor is there warrant for the courts to read such a requirement into the statute.[55]

Thus, so long as the board satisfies its duty of disclosure with respect to the offending interest at hand, the requisite vote of all stockholders—interested and disinterested alike,[56] subject to the "good faith" requirement—will grant a covered transaction the safe-harbor benefits of section 144. Few cases squarely address what constitutes an "informed" stockholder vote under section 144(a)(2). But when a board of directors submits any transaction to the stockholders for approval, it must comply with its fiduciary duty of disclosure and, to the extent the board is found to have so complied, the stockholder vote will be found to have been taken on an informed basis, as required under section 144(a)(2).[57]

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[54]FOLK, *supra* note 21, at 71; *see also* Arsht & Stapleton, *supra* note 25, at 82 ("Limiting the stockholder vote to disinterested stockholders was considered administratively unfeasible and seems unnecessary where the effect of the statute is not necessarily to validate the transaction but simply to put it on the same footing as any other corporate transaction.").

[55]FOLK, *supra* note 23, at 85-86 (footnotes omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 900 n.80 (Del. Ch. 1999) (discussing the historical common-law rules for ratification by interested stockholders).

[56]*But see* discussion *infra* note 102.

[57]Nebenzahl v. Miller, No. 13,206, 1993 Del. Ch. LEXIS 249, at *11 (Del. Ch. Nov. 8,

C. *Section 144(a)(3)—Fairness*

A covered transaction may also receive section 144's safe-harbor protection if it is fair to the corporation as of the time it is authorized, approved, or ratified.[58] Section 144(a)(3) therefore operates as a fail-safe mechanism, implicated only where the contract or transaction at issue was not properly approved by the disinterested directors under section 144(a)(1) or the stockholders under section 144(a)(2), or was otherwise incapable of approval under those subsections. Because section 144 operates in the disjunctive, a covered transaction need only comply with one of the three tests. If a covered transaction is approved in compliance with section 144(a)(1) or 144(a)(2), a court will not reach the question of entire fairness under section 144(a)(3).[59] As the Delaware Court of Chancery noted in *Nebenzahl v. Miller*,[60] "It certainly seems unlikely the General Assembly intended the same Director Defendants, who have made full disclosure and whose contemplated transaction has received the blessings of a majority of disinterested directors and a majority of shareholders, to defend against a claim the transaction was nonetheless unfair."[61] The plain text of the statute reveals its disjunctive

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1993), *reprinted in* 19 DEL. J. CORP. L. 834, 841-42 (1994) ("Section 144(a)(2) would protect the merger in the event of the required shareholder approval. It has not been alleged that the Proxy Statement failed to disclose the material facts of the merger, including the information about the contested 'special benefits' package."). Although a more detailed review of the duty of disclosure is outside the scope of this article, it may be generally noted that, under Delaware law, in disclosing matters relating to a significant transaction to a corporation's stockholders, the board must fully disclose all facts within its control that would be material to the stockholders' decision to approve or reject the transaction. *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1276-77 (Del. 1994); Clements v. Rogers, 790 A.2d 1222, 1236 (Del. Ch. 2001) ("The Delaware fiduciary duty of disclosure is not a full-blown disclosure regime like the one that exists under federal law; it is an instrumental duty of fiduciaries that serves the ultimate goal of informed stockholder decision making."). The information disclosed must be truthful and accurate. Zirn v. VLI Corp., 681 A.2d 1050, 1058 (Del. 1996) ("The goal of disclosure is . . . to provide a balanced and truthful account of those matters which are discussed in a corporation's disclosure materials."). *See generally* Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1112-15 (1996) (discussing the fiduciary duty of disclosure in the context of ratification). Where a board submits a covered transaction to the stockholders for ratification under section 144(a)(2), this duty of disclosure would extend not only to the contract or transaction itself, but also to the facts and circumstances surrounding the offending interest.

[58]Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 174 (Del. Ch. 2005) ("Even if the requirements of [section] 144(a)(1) were not met, Defendants still could avoid having the interested [covered transaction] rendered void or voidable by proving that it was 'fair as to the corporation' under [section] 144(a)(3)."), *aff'd*, 906 A.2d 114 (Del. 2006).

[59]It may, of course, scrutinize the transaction for entire fairness under the common law of breach of fiduciary duty.

[60]No. 13,206, 1996 Del. Ch. LEXIS 113 (Del. Ch. Aug. 26, 1996) (revised Aug 27, 1996), *reprinted in* 22 DEL. J. CORP. L. 779 (1997).

[61]*Id.* at *12-13, *reprinted in* 22 DEL. J. CORP. L. at 790-91.

nature: "If the General Assembly had so intended, Section 144(a)(3) would have been preceded by 'and' not 'or.'"[62]

The Delaware courts have construed the section 144(a)(3) requirement to mean that the corporation must demonstrate the entire fairness of the transaction.[63] In *Marciano v. Nakash*,[64] the Delaware Supreme Court noted that "a non-disclosing director seeking to remove the cloud of interestedness would appear to have the same burden under section 144(a)(3), as under prior case law, of proving the intrinsic fairness of a questioned transaction which had been approved or ratified by the directors or shareholders."[65] Thus, any covered transaction that fails to meet the requirements of section 144(a)(1) or 144(a)(2) will nonetheless fall within the safe harbor if those defending the covered transaction can demonstrate that it was arrived at through fair dealing and resulted in a fair price.[66]

IV. THE OVEREXTENSION OF SECTION 144

A. *Confusion Regarding Section 144's Proper Role*

Although some outliers have interpreted section 144 differently from the original intention for the statute, the Delaware courts have generally interpreted section 144 in the way it was intended. One case recognizing the issue is *In re Cox Communications, Inc. Shareholders Litigation*.[67] *Cox* explicitly dealt with an objection to a request for attorneys' fees, but the complaint in the underlying action challenged a going-private merger by the

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[62]*Id.* at *13, *reprinted in* 22 DEL. J. CORP. L. at 791 ("A requirement for a court to find 'the transaction fair to the corporation' seems to be relevant only where full disclosure has not been made to either a majority of disinterested directors or a majority of shareholders before obtaining their approval of the transaction."); *see also* FOLK, *supra* note 21, at 71-72 ("It is again stressed that the tests are alternative, any one of which validates the transaction, and the draft has made this clear to avoid any argument that, for example, the stricter 'fairness' test is read into the disinterested director or shareholder ratification tests.").

[63]*See, e.g.*, HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 114 (Del. Ch. 1999) (stating that "under [section] 144(a)(3), a 'non-disclosing interested director can remove the taint of interestedness by proving the entire fairness of the challenged transaction'") (quoting Cede & Co. v. Technicolor Inc., 634 A.2d 345, 366 n.34 (Del. 1993)).

[64]535 A.2d 400 (Del. 1987).

[65]*Id.* at 405 n.3; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) ("The entire fairness test is codified and has been construed by this Court many times.") (citing DEL. CODE ANN. tit. 8, § 144(a)(3)).

[66]*See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (defining entire fairness to involve scrutiny of fair price and fair dealing).

[67]879 A.2d 604 (Del. Ch. 2005).

Cox family, which owned a controlling stake in Cox Communications.[68] The court briefly revisited the pertinent history of section 144's purpose, noting that Delaware corporate law "had long accepted the notion that it was unwise to ban interested transactions altogether"[69] and that the 1967 DGCL "addressed interested transactions by crafting a legal incentive system for vesting decision-making authority over such transactions in those who were not burdened with a conflict."[70] The court laid out section 144's methods for curing an interested transaction (majority of disinterested directors or stockholder ratification) and started to describe section 144 almost as a codification of the business judgment rule: "By those methods, respect for the business judgment of the board can be maintained with integrity, because the law has taken into account the conflict and required that the business judgment be either proposed by the disinterested directors or ratified by the stockholders it affects."[71]

The court paused, however, and reiterated the original intent of section 144. "Lest I be chastened by learned commentators on our law," Vice Chancellor Strine wrote, "I must hasten to add that [section] 144 has been interpreted as dealing solely with the problem of per se invalidity; that is, as addressing only the common law principle that interested transactions were entirely invalid and providing a road map for transactional planners to avoid that fate."[72] The Vice Chancellor went on to note that the "different question of when an interested transaction might give rise to a claim for breach of fiduciary duty—i.e., to a claim in equity—was left to the common law of corporations to answer. Mere compliance with [section] 144 did not necessarily suffice."[73] Nevertheless, the *Cox* court could not ignore the similarities between section 144 and the common law's business judgment rule: "[T]he common law of corporations also was centered on the idea of the business judgment rule and its approach to interested transactions looked much like that codified in [section] 144."[74]

The court in *HMG/Courtland Properties, Inc. v. Gray*[75] made the link between section 144 and the common law even clearer—and, again, correctly. The case involved real estate transactions in which the corporation sold

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[68] *Id.* at 605.

[69] *Id.* at 614.

[70] *Id.*

[71] *Cox*, 879 A.2d at 614.

[72] *Id.* at 614-15.

[73] *Id.* at 615.

[74] *Id.* (noting, however, the different standards of stockholder ratification used in section 144 and the common law).

[75] 749 A.2d 94 (Del. Ch. 1999).

property to two of its directors (and in which one of those directors took the lead in negotiating the sales for the corporation without disclosing his interest in the transactions).[76] The court noted that, although noncompliance with section 144's "disclosure requirement by definition triggers fairness review rather than business judgment rule review, the satisfaction of [sections] 144(a)(1) or (a)(2) alone does not always have the opposite effect of invoking business judgment rule review that one might presume would flow from a literal application of the statute's terms."[77]

That is, the court recognized that there was no necessary relationship between section 144 and the choice between entire fairness or the business judgment rule. While noncompliance with section 144(a)(1) or (a)(2) also happens to be the kind of action that deprives a board's approval of a covered transaction of the presumptions of the business judgment rule, section 144 does not play any role in determining which standard of review applies. As the court noted, "[S]atisfaction of [sections] 144(a)(1) or (a)(2) simply protects against invalidation of the transaction 'solely' because it is an interested one. As such, [section] 144 is best seen as establishing a floor for board conduct but not a ceiling."[78] As this article aims to make clear, section 144 is also the starting point, or "floor," for a court's analysis of a covered transaction: if section 144 is complied with, the floor starts in the common law of breach of fiduciary duty; if section 144 is not complied with, the floor starts in the common law of voidability.

B. *Why Section 144 is Overextended*

It is quite easy to see why courts and practitioners might refer to section 144 as sort of a shorthand even when discussing an analysis reserved to the common law: section 144's three factors are also used in the common-law analysis. That is, (1) approval by disinterested directors, (2) stockholder ratification, and (3) fairness of the transaction, are involved in both the section 144 safe harbor and the common law's transactional analysis. Section 144 and its three factors, therefore, easily slip into discussion of a common-law analysis, even though the two analyses are separate, with different specific factors and different purposes.[79] Whether this overextension is due primarily

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[76]*Id.* at 96.

[77]*Id.* at 114 n.24.

[78]*HMG/Courtland Properties*, 749 A.2d at 114 n.24 (citation omitted).

[79]It cannot be denied, however, that compliance with section 144 is a solid first step toward a transaction that also merits the presumption of the business judgment rule (or at least a shift in the burden of demonstrating entire fairness). *See* FOLK, *supra* note 21, at 74 ("Since the draft statute gives directors and officers a privilege of dealing with their corporation, they are unlikely to

to overreaching by practitioners, harmless inattention, or slipshod shorthand is not for this article; we merely point out that some language in the body of Delaware case law seems to conflate the two analyses in a manner that diverges from the original intent of section 144.

1. Director Approval and Stockholder Ratification

The best demonstration of the separateness of the section 144 and common-law analyses is that, although they use nominally similar factors (disinterested director approval and stockholder ratification), the factors in practice are different.

As noted above, section 144(a)(1) provides that a covered transaction will not be void or voidable solely as a result of the offending interest if it is approved by an informed "majority of the disinterested directors, even though the disinterested directors be less than a quorum."[80] Under the section 144 statutory analysis, so long as there is one informed, disinterested director on the board, and so long as he or she approves the transaction in good faith, the transaction will not be presumptively voidable due to the offending interest. In other words, a nine-member board with a single disinterested director may approve a covered transaction and reap the benefits of the section 144 safe harbor.

Under the common law, however, the factor is somewhat different; approval must be by a disinterested majority of the entire board. That is, a plaintiff may rebut the presumption of the business judgment rule by showing that "a majority of the individual directors were interested or beholden."[81] In the common-law analysis, therefore, a transaction approved by the nine-member board discussed above (with the single disinterested director) will be subject to the entire-fairness standard.[82] The standards are phrased similarly

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be held liable if the transactions are not voidable."). Of course, section 144 and the common-law analysis are two separate hurdles. Although the section 144 hurdle is often lower than the common-law hurdle, in certain cases (such as the fairness analysis under section 144(a)(3)), the two hurdles are of equal height.

[80] DEL. CODE ANN. tit. 8, § 144(a)(1) (2006).

[81] Gantler v. Stephens, No. 2392-VCP, 2008 Del. Ch. LEXIS 20, at *27 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 540 (2008); *see also* Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003) ("The rubric that plaintiff invokes is correct as a general matter—namely that when the majority of a board of directors is the ultimate decisionmaker and a majority of the board is interested in the transaction the presumption of the business judgment rule is rebutted."); Brehm v. Eisner, 746 A.2d 244, 257 (Del. 2000) ("In this case, the issues of disinterestedness and independence involved in the first prong of *Aronson* are whether a majority of the New Board, which presumably was in office when plaintiffs filed this action, was disinterested and independent.").

[82] Interestingly, if a covered transaction is one that may be approved by a committee of the board under section 141(c) of the DGCL, the committee (if composed of a majority of disinterested

for the statutory and common-law analyses, but they are in fact quite different.[83]

Likewise, section 144(a)(2) provides that a covered transaction will not be void or voidable solely by virtue of the offending interest if the transaction is approved by an informed, good-faith "vote of the shareholders."[84] Under section 144, therefore, the interested directors' own votes—in their roles as stockholders—can be counted to ensure that the covered transaction falls within the section 144 safe harbor, so long as they vote for the transaction in good faith. In a corporation in which the interested directors own fifty-five percent of the shares, they can theoretically reach the section 144 safe harbor if they approve the transaction, even if the other forty-five percent of the stockholders vote against the transaction.

Under the common law, again, a slightly different standard for ratification is used.[85] Common-law ratification of an interested transaction may be effectual "only if a majority of the *disinterested* shares outstanding were cast in favor of the transaction."[86] In the example given above, the transaction likely would not be ratified unless a majority of the forty-five percent of the outstanding shares held by the disinterested stockholders were cast in favor of ratifying the transaction.[87]

Though section 144 and its two approval factors are often used in shorthand to describe an analysis under the common law, this is a slipshod shorthand. The figure below sets forth a simplified view of the differences in

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directors) may approve the covered transaction, and that transaction would likely be entitled to the presumption of the business judgment rule as well as satisfy section 144(a)(1).

[83]Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a merger transaction that, although approved in compliance with section 144(a)(1) because its terms were approved by a special committee, nonetheless might have been reviewed for entire fairness because a majority of the board might have been interested).

[84]DEL. CODE ANN. tit. 8, § 144(a) (2006).

[85]*See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005).

> By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve. The common law, by contrast, only gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.

Id. (footnotes omitted).

[86]*In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 Del. Ch. LEXIS 158, at *55 (Del. Ch. Aug. 18, 2006), *reprinted in* 32 DEL. J. CORP. L. 654, 677 (2007) (emphasis added); *see also Gantler*, 2008 Del. Ch. LEXIS 20, at *60, *reprinted in* 33 DEL. J. CORP. L. at 554 (reiterating the requirement that a majority of the disinterested shares vote in favor of the covered transaction).

[87]*See generally* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (denying an attempt to use the ratification standards in section 144(a)(2) to cleanse a transaction in a common-law analysis).

these two factors depending on whether the factors are implicated in the statutory analysis or the common-law analysis.[88]

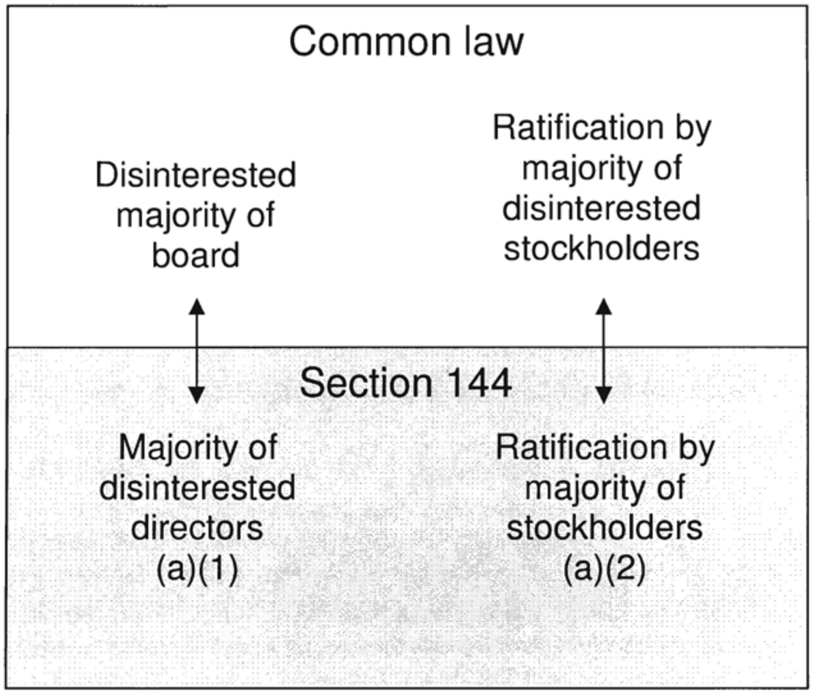

Fig 1. Distinction Between Common Law and Section 144

2. Fairness

Section 144 and the common law overlap even more when it comes to fairness—the factor set forth in section 144(a)(3). Confusion between section 144's fairness test and the common law's fairness test is undeniable, though the confusion may be mitigated by an observation that the two tests are virtually identical. As indicated above, the Delaware Supreme Court has stated that a party seeking to demonstrate compliance with section 144(a)(3) and a party seeking to demonstrate the entire fairness of a transaction have the same burden.[89]

While the fairness inquiry under section 144(a)(3) and the common-law entire-fairness test are virtually the same, their application is different. The purpose of the statutory inquiry is to determine whether a covered transaction

[88]*But see* discussion *infra* note 102.
[89]Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

is presumptively void or voidable as a result of the offending interest; the purpose of the common-law inquiry is typically to determine whether a transaction may be enjoined or may lead to liability.[90] The commonality of the fairness inquiry in each context may cause confusion; nevertheless, the realm of its application should always be clear. Moreover, given the relative paucity of case law applying section 144(a)(3) in a statutory fairness analysis, a simple rule of thumb is that most fairness inquiries are performed under the common law's analysis.

For the most recent example, the Delaware Court of Chancery's 2007 *Valeant* opinion—though it did not cite to section 144(a)(3)—performed a dual section 144/common-law review under entire fairness.[91] The plaintiff in *Valeant* sought damages from a corporation's director and officer for breach of the duty of loyalty related to a self-dealing transaction.[92] In its analysis, the court considered section 144 and determined that entire fairness was the appropriate standard of review because the transaction had not been approved under section 144(a)(1) or ratified under section 144(a)(2).[93] The court engaged in an in-depth analysis of entire fairness and ultimately found the price and process unfair.[94] The court therefore deemed the transaction voidable and found the defendant liable for breach of fiduciary duty.[95]

With respect to section 144, *Valeant*'s multi-step analysis may not have been clear, particularly because those steps seemed to occur all at once. But what actually happened is this: because neither (a)(1) nor (a)(2) had been complied with, the court had to undertake a section 144(a)(3) analysis to determine whether the transaction would be voidable solely for being an interested-director transaction. A section 144(a)(3) analysis involves scrutiny under the entire-fairness standard.[96] The court engaged in the entire-fairness analysis and found the transaction unfair.[97] The section 144 safe harbor therefore did not apply, and the common law of voidability did. The court accordingly deemed the transaction voidable.[98]

The court also applied the common-law rules for liability for breach of fiduciary duty. The test for entire fairness had already been performed, and the transaction failed the test, so the court could impose liability under the

[90] *See id.* at 403-04.
[91] Valeant Pharms. Int'l v. Jerney, 921 A.2d 732 (Del. Ch. 2007).
[92] *Id.* at 735-36.
[93] *Id.* at 745-46.
[94] *Id.* at 746-50.
[95] *Valeant*, 921 A.2d at 752.
[96] *Id.* at 745.
[97] *Id.* at 746-50.
[98] *Id.* at 752.

common law for breach of fiduciary duty.[99] The two conclusions, however, were separate—voidability under the common law for interested transactions, and liability under the common law for breach of fiduciary duty.[100]

Had the court found the transaction to have been entirely fair, the likely scenario would have been: (1) the transaction complied with the section 144 safe harbor under section 144(a)(3), (2) the transaction would not have been voidable solely for the reason that it was an interested-director transaction, and (3) the court could then have scrutinized the transaction under the common law for breach of fiduciary duty. The court's analysis under the common law for breach of fiduciary duty likely would have relied on its earlier finding of entire fairness and would therefore have resulted in no liability.

C. *Evidence of Overextension*

Whether as a matter of misplaced shorthand, as a matter of litigants' confusion, or as a matter of inapt judicial phrasing, several Delaware cases have seemed to apply section 144 outside its limited scope. In *Marciano*, for example, the court stated that "approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."[101] This statement is partly correct[102] in that

[99] *Valeant*, 921 A.2d at 752.

[100] *See id.* at 752 & n.45.

[101] Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987). By its own terms, however, section 144(a)(2) does not require *disinterested* stockholder ratification. Section 144 refers only to a "vote of the shareholders," making no mention of disinterested stockholders, who are part of the common-law analysis. DEL. CODE ANN. tit. 8, § 144(a)(2); *see also In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005) (" By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve. The common law, by contrast, only gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.") (footnotes omitted); *supra* text accompanying notes 85-88.

Nonetheless, it could be argued that *Marciano* represents a judicial gloss on section 144(a)(2) by the Delaware Supreme Court and that section 144(a)(2) now *does* require ratification by disinterested stockholders. While risk-averse practitioners should heed such warnings, we believe that *Marciano* is not a judicial gloss on section 144. First, section 144 was "unavailable" in *Marciano*, and the defendants did not even "attempt[] to invoke section 144," so the court's statement was merely dicta. *Marciano*, 535 A.2d at 404. Second, the court was not discussing per se invalidity, to which section 144 applies, but the common law of breach of fiduciary duty (including the business judgment rule), in which stockholder ratification requires a vote of the disinterested stockholders. *See Cox*, 879 A.2d at 615; *see also Marciano*, 535 A.2d at 404 (noting that, under the common-law analysis, "shareholder control by interested directors precludes independent review" and that, because "shareholder deadlock prevent[ed] ratification," section compliance with section 144 *permits* invocation of the business judgment rule (in the sense that a transaction that is not void is eligible to receive scrutiny under the common law, which includes the business judgment rule). If a transaction fails to comply with section 144, it would be void under the common law, and the business judgment rule would never have a chance to apply. That is not, however, the interpretation that all other courts have put on *Marciano*'s statement; some later courts seemed to adopt an overextended view of section 144.[103]

In *Oberly v. Kirby*,[104] the Delaware Supreme Court stated that courts "will defer to the business judgment of outside directors that an interested transaction is fair to the corporation," citing section 144.[105] The court also noted that "section 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule."[106] If the court was suggesting that compliance with section 144 plays a role in the common-law presumption of the business judgment rule, it would seem the court was incorrect.[107] The way to read *Oberly*'s statement as

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144(a)(2) did not apply). Third, the contemporaneous drafting history suggests that section 144(a)(2) was not intended to apply only to disinterested stockholders. *See supra* text accompanying notes 54-55. Fourth, it is not always true that ratification of disinterested stockholders provides the protection of the business judgment rule; for example, if a controlling stockholder is involved in the transaction, such a ratification will only shift the burden of entire fairness. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

For these four reasons, a similar statement in the *Cede* case should also not be considered judicial gloss on section 144. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors, [section] 144(a)(1), or the disinterested shareholders, [section] 144(a)(2), provides business judgment protection.") (citing *Marciano*, 535 A.2d at 405 n.3, *modified*, 636 A.2d 956 (Del. 1994)). The statement in *Cede* is even more problematic, as it also purports to rewrite section 144(a)(1), modifying the test to approval by a "disinterested board," rather than by the disinterested directors. We also note that section 144 did not apply in *Cede*. *See infra* note 111.

[102]But compliance with section 144 merely ensures that a transaction will not be found void or voidable *solely* because directors are interested in the transaction. *See* DEL. CODE ANN. tit. 8, § 144(a) (2006). Section 144, by definition, *allows* review for other transactional defects, such as gift or waste, and entire fairness can easily apply if a majority of the board is interested, for example, even if section 144 is complied with.

[103]*See, e.g.*, Rosser v. New Valley Corp., No. 17,272-NC, 2005 Del. Ch. LEXIS 81, at *16-19 (Del. Ch. May 27, 2005).

[104]592 A.2d 445 (Del. 1991).

[105]*Id.* at 465 n.14 (citing DEL. CODE ANN. tit. 8, § 144(a)(1)).

[106]*Id.* at 466.

[107]Not only is this a faulty extension of section 144's limited statutory purpose, but it also fails to recognize that, even if a merger is approved by a committee of disinterested directors, the board's decision will not necessarily receive the presumption of the business judgment rule unless a majority of the board was disinterested in the merger and so long as the merger is not a transaction with a controlling stockholder. *See* Gantler v. Stephens, No. 2392-VCP, 2008 Del. Ch. LEXIS 20, at *27 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 540 (2008).

consistent with section 144's proper application is that section 144 removes the "interested-director taint" of a transaction and *allows*—but does not mandate—the application of the business judgment rule. That is, as discussed above, compliance with section 144 ensures that a court's analysis of a transaction begins at the level of the common law of breach of fiduciary duty, which could potentially include the presumption of the business judgment rule.[108]

The Delaware Supreme Court, four years later, quoted *Oberly*'s language in *Cinerama, Inc. v. Technicolor, Inc.*[109] The court in *Cinerama*—noting that, in neither case, did section 144 apply[110]—was more careful with its language and set forth the similarities between section 144 and the common law. The court suggested that *Oberly* had merely "relied upon the provisions in . . . [section 144] to illustrate the general principle that, as to the duty of loyalty," approval by disinterested directors can restore the presumption of the business judgment rule.[111] As the court of chancery held, in a passage quoted with approval[112] by the *Cinerama* court, section 144 "does not deal with the question of when will a financial interest of one or more directors cast on the board the burdens and risks of the entire fairness form of judicial review."[113] "Rather," the court of chancery stated, section 144 "deals with the *related* problem of the conditions under which a corporate contract can be rendered 'un-voidable' solely by reason of a director interest."[114] The language in

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> The burden is on the party challenging the decision to establish facts rebutting the presumption [of the business judgment rule]. Generally, that party must allege sufficient facts from which the court could reasonably infer (1) *a majority of the individual directors were interested* or beholden or (2) the challenged transaction was not otherwise the product of a valid exercise of business judgment.

Id. (emphasis added) (footnotes omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a plaintiff's burden of asserting facts sufficient to overcome the business judgment rule).

[108]The *Valeant* court in 2007 recognized this: "[S]ection 144 allows a committee of disinterested directors to approve a transaction and, at least potentially, bring it within the scope of the business judgment rule." Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 745 (Del. Ch. 2007).

[109]663 A.2d 1156, 1170 (Del. 1995).

[110]*Id.* at 1169 ("In this appeal, Cinerama acknowledges that Section 144 is not directly applicable to this case."); *id.* at 1170 (stating that "[i]n *Oberly*, . . . Section 144(a) did not apply to the action being contested"). Notably, it was the Delaware Supreme Court that injected section 144 into the case originally. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 350 (Del. 1993) (directing the court of chancery to "address[] the relevance and effect of the interested-director provisions of [section 144] upon," among other things, "the business judgment rule's requirement of director loyalty"), *modified*, 636 A.2d 956 (Del. 1994).

[111]*Cinerama*, 663 A.2d at 1170.

[112]*Id.* at 1169 (noting that the "Court of Chancery properly began its consideration of Section 144 with the following comment").

[113]*Id.* (internal quotation marks omitted).

[114]*Id.* (emphasis added) (internal quotation marks omitted).

Cinerama therefore recognizes that, although section 144 and the common law share factors (disinterested director approval, stockholder ratification, and fairness review), their inquiries are separate.[115]

The minor unclarity in the language of *Oberly* and *Cinerama*, however, may have led to later cases further extending section 144 beyond its original purpose. In *Wheelabrator*,[116] the Delaware Court of Chancery suggested that "application of [section] 144(a)(1)" played a part in the court's decision that "the review standard applicable to th[e] merger [in question] is business judgment, with the plaintiffs having the burden of proof."[117] If what the court meant was that approval by a majority of the disinterested directors, by removing the transaction from the clutches of the common law regarding voidability and placing the transaction into the realm of the common law regarding liability, allowed for the application of the business judgment rule, it was correct. But section 144 has no effect on whether business judgment or entire fairness applies. For example, if a majority of the board were interested in a covered transaction, a stockholder-plaintiff challenging the transaction could, on that basis, rebut the presumption of the business judgment rule—even though section 144(a)(1) may have been complied with.

The Delaware Court of Chancery's 1996 *Nebenzahl* decision went even further, suggesting that "[s]ection 144 may provide the protection of the business judgment rule to self-interested directors who approve a transaction shareholders later challenge" and that, if the director satisfied section 144, the stockholder-plaintiff would have to "bear the burden of pleading facts which allege the transaction to be unfair."[118] Even more strongly, the court stated that "[c]ompliance with Section 144 provides the protection of the business judgment rule and removes the taint of director self-interest in a transaction."[119] But a breach of the duty of care could lead to review for entire fairness, even if the transaction complied with section 144(a)(2). The court's statement represents an overextension of section 144's power and purpose. *Nebenzahl* did, however, correctly note that a plaintiff who proves a covered transaction unfair can both impose liability on directors *and* render the transaction voidable[120]—a point rarely recognized regarding the dual fairness inquiries inherent in the statutory and common-law analyses.

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[115] *Cinerama*, 663 A.2d at 1169.

[116] *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995).

[117] *Id.* at 1205 & n.8.

[118] Nebenzahl v. Miller, No. 13,206, 1996 Del. Ch. LEXIS 113, at *10 (Del. Ch. Aug. 26, 1996) (revised Aug. 29, 1996), *reprinted in* 22 DEL. J. CORP. L. 779, 789-90 (1997).

[119] *Id.* at *10-11, *reprinted in* 22 DEL. J. CORP. L. at 790.

[120] *Id.* at *11, *reprinted in* 22 DEL. J. CORP. L. at 790. The transaction would not be voidable solely by reason of the offending interest, however, if the covered transaction complied

In the 2000 *Cooke v. Oolie* case, the Delaware Court of Chancery recognized that section 144 did not apply to the transaction in question.[121] Nevertheless, the court stated that "[u]nder [section] 144(a)(1), this Court will apply the business judgment rule to the actions of an interested director, who is not the majority shareholder, if the interested director fully discloses his interest and a majority of the disinterested directors ratify the interested transaction."[122] Again, section 144 is unrelated to the business judgment rule's application per se—and the presumption of the business judgment rule, with regard to a transaction, can be rebutted even if section 144(a)(1) is complied with. It seems that the court in *Cooke* merely used the concept of the section 144 "safe harbor" as a shorthand to refer to the factors of ratification by disinterested directors or ratification by stockholders.[123] For example, the court stated that "satisfying the requirements of the safe harbor provision would have merely shifted the burden of proving entire fairness to the plaintiffs."[124] But when a controlling stockholder is involved, approval by a special committee of disinterested directors (enough to reach the safe harbor of section 144(a)(1)) is not *itself* enough to shift the burden of proof.[125] The *Cooke* court was, however, correct when it noted that "the rationale behind the Legislature's creation of the [section 144] safe harbor is on all fours with [the] . . . disinterested directors' ratification of the challenged action currently before the Court."[126] The rationale was the same, though the factors are a little different in the common-law analysis.

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with section 144(a)(1) or (a)(2). *Cf.* Reddy v. MBKS Co., 945 A.2d 1080, 1087-88 & n.15 (Del. 2008) (holding an interested transaction void where no disinterested directors voted on the transaction, where (apparently) no stockholders ratified the transaction, and where the interested director could not prove the transaction was fair).

[121] No. 11,134, 2000 Del. Ch. LEXIS 89, at *44 & n.39 (Del. Ch. May 24, 2000), *reprinted in* 26 DEL. J. CORP. L. 609, 627 & n.39 (2001).

[122] *Id.* at *44, *reprinted in* 26 DEL. J. CORP. L. at 627.

[123] The court did, however, also suggest that section 144 played some role in determining liability, which it does not. *See id.* at *46 n.41, *reprinted in* 26 DEL. J. CORP. L. at 628 n.41 ("Once the plaintiffs demonstrate interest, the burden shifts to the defendants to show that one of [section] 144's safe harbor provisions protects *them* and the transaction.") (emphasis added).

[124] *Id.*

[125] *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("The mere existence of an independent special committee . . . does not itself shift the burden"; the courts engage in "careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness.") (omission in original) (internal quotation marks omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a merger transaction that, although approved in compliance with section 144(a)(1) by virtue of the independent special committee approval, nonetheless might have been reviewed for entire fairness because a majority of the board might have been interested and because the special committee might not have been sufficiently independent).

[126] *Cooke*, 2000 Del. Ch. LEXIS 89, at *45, *reprinted in* 26 DEL. J. CORP. L. at 628.

While other examples of misstatements about section 144 may exist, it is not our goal to find them all. For years practitioners have pushed hard in both directions—either to reap a protective benefit from the "penumbras" and "emanations"[127] of section 144 or to drain the three safe-harbor factors of any effect—and it is no surprise that the courts have engaged in use of shorthand when sorting out such disputes. Some might think that this article has no purpose, seeing as how it merely restates something that is, by most accounts, perfectly clear from the statutory language alone. But we believe that the confusion about section 144 causes problems for practitioners, and headaches for the courts, and that a restatement by the Delaware courts of the proper role and structure of section 144 would be a great service to all. The problem with allowing section 144 to bleed into the common law is that it can lead to more confusion, unintended redundancies, and incorrect legal advice to clients.[128]

V. CONCLUSION

Although section 144 was designed to provide a safe harbor against the specter of voidability for a limited subset of transactions in which directors of the corporation were interested and that would have been found voidable under the pre-1967 common law, it has, in the years following its adoption, been misconstrued to provide business-judgment protection to transactions complying with its terms. This result has no basis in the statute itself; the legislative history surrounding the adoption thereof, and certain cases interpreting the statute, dispel such a proposition. Section 144 is extremely limited in scope: it merely provides that a covered transaction will not be

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[127]Griswold v. Connecticut, 381 U.S. 479, 484 (1965) (stating that "specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance").

[128]First, practitioners might mistakenly rely on section 144 to avoid entire-fairness review. *See supra* text accompanying notes 3-11 (discussing *Fliegler* and *Benihana*). Second, practitioners might give their clients legally inaccurate advice. For example, in the 1985 *Lewis v. Fuqua* case, a (one-man) special litigation committee reviewed a derivative action and recommended the dismissal of that action. Lewis v. Fuqua, 502 A.2d 962, 965-66 (Del. Ch. 1985). Among other things, the court noted: "In regard to th[e] interested director issue, the Committee recognized three separate tests of liability," including the first one—"a test based on Section 144 of the Delaware General Corporation Law." *Id.* at 970. Of course, as discussed several times above, section 144 is not a test of liability.

Clarification of section 144 may help in other ways as well. For example, in *Pfeffer v. Redstone*, the court dismissed a count in a plaintiff's complaint seeking to void a transaction as an interested transaction under section 144. Pfeffer v. Redstone, No. 2317-VCL, 2008 Del. Ch. LEXIS 12, at *45-47 (Del. Ch. Feb. 1, 2008). Section 144 did not apply at all—the directors were not on both sides. *Id.* at *46. The count also complained of a breach of fiduciary duty—such claims are for the common law, not for section 144. *Cf. id.* at *45.

voidable *solely* as a result of the offending interest.[129] That is, section 144 determines whether a covered transaction will be scrutinized under the common law of breach of fiduciary duty alone or under both the common law of breach of fiduciary duty *and* the common law of voidability.

Practitioners are cautioned not to construe section 144 to provide more protection than it does. Reliance on the cases suggesting that compliance with the statute, standing alone, results in business-judgment protection could, depending on the circumstances, result in their clients' receiving inaccurate advice with respect to the level of scrutiny that a Delaware court will apply to an interested transaction. Moreover, reliance on the plain text of the statute itself is at practitioners' peril because section 144's invocation in common-law contexts may have resulted in judicial glosses on section 144 that do not match the text.[130]

[129]Some might wonder, therefore, whether section 144 serves any valuable purpose at all. But repeal of section 144 would revert scrutiny of interested transactions back to the pre-1967 common law, in which interested directors did not count toward a quorum. *See supra* text accompanying notes 13-20. Without a compensating change in the common law, section 144 plays a small but crucial role and should be retained, albeit in its original, limited application. Nevertheless, a possible statutory revision could mitigate the confusion that has arisen over the proper role and application of section 144: section 144 could be amended by deleting from section 144(a) the text following the phrase "counted for such purpose," and replacing it with "provided, however, that nothing in this section shall limit the authority of a court to review the contract or transaction under equitable principles." That is, the three tests in (a)(1), (a)(2), and (a)(3) would be eliminated from the statute. Such an amendment would retain the principal function of the statute—the reversal of the common law regarding voidability of interested transactions—but allow Delaware courts to invalidate or enjoin those transactions under the principles of equity. *Cf.* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

[130]*See, e.g.*, discussion *supra* note 102.

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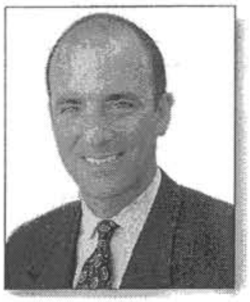
The BackPage

News for Associates and Young Lawyers

Legal Writing

KENNETH A. ADAMS



DRAFTING MATTERS

In the considerable body of literature devoted to legal writing, it is usually taken as a given that most lawyers write poorly. Since drafting is simply a form of writing used in legal instruments that seek to regulate conduct (principally statutes, regulations, wills and contracts), it should come as no surprise that many commentators think that most lawyers *draft* poorly.

I, too, have come to the conclusion, based on my experience drafting, reviewing and negotiating contracts as a corporate lawyer in private practice, that many contracts are in fact inexpertly drafted and that almost all show room for improvement. I mean by this that many contracts use language that is less precise and efficient than it might be and are structured in a way that makes them less accessible to the reader. Common drafting inefficiencies include gratuitous archaisms (such as the *WITNESSETH* that often precedes recitals); unhelpful use of verbs (in particular rampant overuse of *shall*); redundant synonyms (instead of having Jones *sell* shares to Smith, the typical drafter might have Jones *sell, convey, assign, transfer and deliver* them); inefficient typography (for instance, use of Courier typefaces and full justification); and inefficient layout.

Does it matter that many contracts are indifferently drafted? I suggest that it does, for three reasons. First, a party to a contract could discover, after signing, that because of a modest drafting flaw, such as a defined term that is ambiguous or unthinking reliance on legalese, a given provision does not in fact mean what that party thought it meant. This mishap could deprive that party of an anticipated benefit under the contract or could result in a dispute leading to litigation.

Second, the more a contract is riddled with legalese and burdened with a clumsy structure, the more time-consuming and therefore expensive it will be to read, negotiate, and interpret.

Third, a poorly drafted contract risks alienating the lay reader: as contract language strays from everyday English to legalese, the drafter becomes less the professional and more the occultist, muttering incantations over chicken entrails.

A factor that helps perpetuate indifferent drafting is that its harmful effects are generally more subtle than mistaken interpretations of law or problems relating to the structure of a transaction. As a result, many corporate lawyers are quick to dismiss questions of legal usage as going to form rather than substance and are complacent about their own drafting abilities. One consequence of this is that junior corporate lawyers often receive little training in drafting and rely on flawed form contracts, leading them to unwittingly perpetuate poor drafting techniques.

A symptom of the profession's general indifference is the lack of a comprehensive guide to the conventions of language and structure used in drafting contracts. This lack has also contributed to that indifference, as corporate lawyers have had little in the way of standards against which to measure their drafting.

While writing my book, *Legal Usage in Drafting Corporate Agreements*, I considered the arguments that could be offered to counter my assertion that many lawyers are indifferent drafters and that poor drafting can have damaging consequences. These counterarguments can be summarized as follows: that current standards of drafting are entirely adequate, as legal documents reflecting those standards facilitate the countless transactions that are accomplished daily; that while much contract language might seem wordy and archaic, that is the price you pay for precision; that case law has settled the meaning of much legal vocabulary, leaving the drafter with little discretion; and that

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since the law is inherently complex, so too, inevitably, are contracts.

I acknowledge that these arguments remain popular, but I have not attempted to rebut them. For one thing, others have done so and shown them to be myths or irrelevant. More to the point, however, I find it unhelpful to deal in generalities. I prefer instead to assess the various ways of addressing any given drafting issue and then advocate the approach that seems the clearest or most efficient, my guiding principle being that unless there are cogent reasons to do otherwise, one should use standard English.

That said, I hesitate to call myself an advocate of "plain English" or "plain language." My principal reservation is that while many of the issues that arise in contract drafting fall within the orbit of plain-English principles as broadly conceived, many others do not. For example, the question of whether the traditional recital of consideration included in most contracts serves any useful purpose (it does not) is primarily a matter of contract law rather than plain English.

Legal English

Less well-known than plain English is the concept of "legal usage." It is commonplace to refer to "English usage" in connection with studies of different forms of speech. This term has spawned the variant "legal usage," which applies to legal speech. "Legal usage" describes better the scope of my concerns than does "plain English," and it also has the advantage of being not as loaded a term. Perhaps wider awareness of the concept of legal usage will help convey the message that if instead of blindly following flawed precedent you aim for optimal grammar, syntax, word selection, and document design, the contracts you draft will be significantly more efficient and readable.

And once lawyers recognize that there is an alternative to current drafting standards, there are significant incentives, in the form of a carrot and a stick, that should encourage them to adopt modern and efficient drafting usages. The language and structure of contracts is inherently more limited and stylized than that of, say, an appellate brief, and so can be more readily mastered, given suitable reference sources. At the same time, the incentives to master drafting are greater than in general legal writing: every provision of a contract carries weight and must stand or fall on its own, whereas in other forms of legal writing a poorly crafted sentence is more likely to be borne along by the narrative.

An Illustration

To illustrate my approach, consider *notwithstanding*. It is a regular fixture in corporate agreements: "Notwithstanding any provision of Section 3.2, Acme may own 1 percent or less of a publicly traded company." In this sentence, *notwithstanding* means "in spite of" or "despite" and serves to indicate that while the subject matter of Section 3.2 overlaps with that of the quoted sentence, the quoted sentence should be read and interpreted as if Section 3.2 did not exist.

Similarly, you can subordinate an entire agreement to a given provision by placing before that provision the old chestnut *notwithstanding anything herein to the contrary*, while *notwithstanding the foregoing* allows you to subordinate the preceding text.

You should, however, avoid *notwithstanding*, because the one or more provisions that it subverts could be at a remove from it. A reader could blithely accept at face value a given contract provision, unaware that it is undercut by a *notwithstanding* several pages later.

Furthermore, while a *notwithstanding* clause that refers to a particular section at least warns the careful reader what is being undercut, one that encompasses the entire agreement leaves to the reader the often awkward task of determining which provisions are affected. Often enough, the answer is none: lazy or harried drafters tend to throw in *notwithstanding anything herein to the contrary* to inoculate particularly significant provisions against conflicting provisions, whether or not there are any.

By the same token, *notwithstanding the foregoing* might seem relatively benign in that the undercut provision is specified and close at hand, but the *foregoing* could conceivably refer to the previous sentence, to entire contract up to that point, or to something in between.

There is an alternative to *notwithstanding*. A contract provision, call it Section 4, requires that Acme pay the Purchase Price to Jones, and another, Section 5, requires that Acme pay $10,000 of the Purchase Price to Smith if the Closing occurs after a given date. Instead of prefacing the latter provision with *Notwithstanding Section 4*, qualify the former provision with *Subject to Section 5*. Using *subject* to allows you to signal the reader that a given provision is undercut by another provision; you do not have to hope that the reader spots a *notwithstanding* elsewhere in the contract.

Note, however, that when you are proposing a change to the other side's draft that would undercut one or more other provisions, using *notwithstanding* rather than *subject to* would allow that change to be self-contained and, in all likelihood, more discreet. Consequently, even drafters who normally use *subject* to sometimes have use for *notwithstanding*.

Affirming the consequent

From Wikipedia, the free encyclopedia

Affirming the consequent, sometimes called **converse error** or **fallacy of the converse**, is a formal fallacy of inferring the converse from the original statement. The corresponding argument has the general form:

1. If P, then Q.
2. Q.
3. Therefore, P.

An argument of this form is invalid, i.e., the conclusion can be false even when statements 1 and 2 are true. Since P was never asserted as the *only* sufficient condition for Q, other factors could account for Q (while P was false).[1]

To put it differently, if P implies Q, the **only** inference that can be made is *non-Q* implies *non-P*. (*Non-P* and *non-Q* designate the opposite propositions to P and Q.) This is known as logical contraposition. Symbolically:

$$(P \to Q) \leftrightarrow (\neg Q \to \neg P)$$

The name *affirming the consequent* derives from the premise Q, which affirms the "then" clause of the conditional premise.

Examples

One way to demonstrate the invalidity of this argument form is with a counterexample with true premises but an obviously false conclusion. For example:

If Bill Gates owns Fort Knox, then he is rich.

Bill Gates is rich.

Therefore, Bill Gates owns Fort Knox.

Owning Fort Knox is not the *only* way to be rich. Any number of other ways exist to be rich.

However, one can affirm with certainty that "if Bill Gates is not rich" (*non-Q*) then "Bill Gates does not own Fort Knox" (*non-P*). This is the contrapositive of the first statement, and it must be true if the original statement is true.

Arguments of the same form can sometimes seem superficially convincing, as in the following example:

If I have the flu, then I have a sore throat.

I have a sore throat.

Therefore, I have the flu.

But having the flu is not the *only* cause of a sore throat since many illnesses cause sore throat, such as the common cold or strep throat.

See also

- Confusion of the inverse
- Denying the antecedent
- ELIZA effect
- Fallacy of the single cause
- Fallacy of the undistributed middle
- Inference to the best explanation
- Modus ponens
- Modus tollens
- Post hoc ergo propter hoc

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Categories: Propositional fallacies | Logic stubs

62 Baylor L. Rev. 433

Baylor Law Review
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Articles

*433 FIRST-REFUSAL RIGHTS UNDER TEXAS LAW

Robert K. Wise [a1] Andrew J. Szygenda [aa1] Thomas F. Lillard [aaa1]

*435 I. Introduction

Among the many ubiquitous provisions in commercial contracts (usually found well toward the back) are rights of first refusal. [1] Because ***436** such provisions often are tangential to a transaction's main purpose, and because the first-refusal right concept seems straightforward--typically, if the right's grantor decides to sell certain property, the right's holder has the right to buy the property on the same terms and conditions set forth in a third party's bona fide offer [2] --practitioners often use a boilerplate first-refusal right from either a form book or a previous contract with little further thought. Consequently, they wholly fail to consider alternative provisions that might meet contracting parties' goals better.

Behind the first-refusal right's seeming straightforwardness, however, lurk questions that repeatedly bedevil Texas courts and practitioners, such as: (1) what triggers the holder's right to exercise the right; (2) what notice must the owner give the holder about a third party's offer and what obligation does the holder have to seek clarification of an incomplete or ambiguous notice; (3) how is the right exercised; and (4) when and under what circumstances does the right terminate?

Long and costly litigation often results when a first-refusal right fails to answer these questions clearly. This Article's purpose not only is to answer them when the first-refusal right fails to do so, but also to provide a ***437** comprehensive guide regarding first-refusal rights under Texas law. Part II describes the first-refusal right in general, distinguishing it from an option and explaining why such provisions are included in contracts. Parts III through VI, respectively, address the questions identified in the preceding paragraph. Part VII discusses the remedies available to a holder of a first-refusal right when the right is breached. Part VIII discusses the affirmative defenses available to a right's grantor and a third party when the holder sues the grantor or the third party in connection with the right's alleged breach. Part IX provides recommendations to practitioners in drafting and exercising first-refusal rights. Finally, Part X discusses alternative provisions that might better meet contracting parties' goals.

II. The First-Refusal Right in General

A. The Typical First-Refusal Right

A first-refusal right affects three parties: (1) the grantor (usually a property owner); (2) the holder; and (3) a third party (usually a potential purchaser of the property burdened by the right). [3] In its simplest form, a first-refusal right gives the holder the right to preempt a contract's execution (or consummation) on the terms provided in the right, which typically require the holder to match, within a specified time period, the price and other terms and conditions contained in a third party's bona fide offer. [4]

The following example illustrates an ordinary first-refusal right's operation. Assume that the owner of two contiguous tracts of land, Blackacre and Whiteacre, sells Whiteacre and grants the buyer a first-refusal right on Blackacre. So long as the grantor is unwilling to sell Blackacre, the holder cannot compel the grantor to do so. [5] However, once ***438** the grantor is prepared to accept a bona fide offer from a third party for Blackacre, the grantor must give the holder an opportunity to preempt the sale by notifying the holder of the sale's proposed terms and conditions. [6]

The grantor's notification creates an option in favor of the holder for Blackacre's purchase at the price and on the other terms and conditions of the third party's bona fide offer. [7] When the holder gives notice of its intent to accept the offer and exercise its option, a contract is created between the holder and the grantor. [8]

*439 B. Diversity in First-Refusal Rights

The parties' rights and obligations under a first-refusal right depend on the right's wording. As first-refusal rights' terms vary widely, courts and practitioners must scrutinize their language carefully to ascertain their scope. [9] Moreover, the applications and variations of such rights are almost infinite. For example, even though most first-refusal rights are used to grant a preemptive right to purchase, [10] a first-refusal right also may be used to grant a preemptive right to sell, [11] a preemptive right to lease, [12] a preemptive right to provide services, [13] a preemptive right to be employed, [14] or a preemptive right to employ. [15]

***440** Most first-refusal rights occur in real property transactions,[16] such as leases,[17] real-estate sales contracts and deeds,[18] and oil and gas instruments.[19] However, a first-refusal right's subject matter can be ***441** anything that can be the subject of contracts, including franchise, distributorship, and dealership agreements,[20] shareholder agreements,[21] employment agreements,[22] and joint venture and partnership agreements,[23] ***442** and have burdened everything from film direction[24] and the right to televise a parade[25] to such assets as a natural gas transmission pipeline,[26] a software company,[27] a television station,[28] cable television franchises,[29] a natural gas liquids fractionation plant,[30] an oil storage facility,[31] a petro-chemical plant,[32] an electric-generating plant,[33] television programming,[34] and a racehorse.[35]

A first-refusal right may be for a limited time period, as in a right to purchase the leased premises during a lease's term, or (subject to rules barring perpetuities and other unreasonable restraints on alienation)[36] perpetual, as in the case of a shareholders' agreement or a deed.

First-refusal rights also can be reciprocal or unilateral.[37] Co-owners often create reciprocal agreements in which each owner grants a first-refusal right to, and receives such a right from, the other owners. A shareholders' agreement is typical, and the corporation itself may hold the right, instead of, or in addition to, its shareholders.[38] Reciprocal first- ***443** refusal rights also may exist between partners, joint venturers, and co-owners of real or personal property who do not have a corporate or partnership structure.[39] The right may run with the asset and be perpetual and assignable, or it may be a personal right that vanishes on transfer or the holder's death.[40]

Alternatively, the first-refusal right may be unilateral, as illustrated by the example involving Blackacre in subpart II.A supra. Such grants typically are contained in real-estate sales agreements, deeds, leases, licenses, and franchise, distributorship, dealership, and employment agreements. In leases; licenses; and franchise, distributorship, and dealership agreements, the right generally will run only for the agreement's term.[41] In the employment context, the right usually extends only for a short period beyond the employment contract's duration.[42]

Alternatives to a first-refusal right based on the terms and conditions of a third party's bona fide offer are a first-refusal right at a fixed priced[43] or a market price, usually set by an independent appraisal.[44] Because of judicial ***444** hostility to fixed-priced, first-refusal rights,[45] they rarely are used today.

As also intimated above, the first-refusal right typically is granted as one element of a larger transaction--in the above example involving Blackacre, the right was incidental to a real property sale. However, parties can contract solely for a first-refusal right. [46]

C. A First-Refusal Right Is Not an Option

Although often associated with options, the first-refusal right is not a true option. [47] An option is an irrevocable offer that gives its holder a unilateral right to trigger the purchase at the option price during the option period. [48] In contrast, a first-refusal right does not give its holder the power ***445** to compel an unwilling owner to sell. [49] Rather, it merely requires the owner, when and if it decides to sell, to offer the property first to the holder, usually at the price and on the other terms and conditions set forth in the third party's bona fide offer. [50] However, as noted above, the right "ripens" into an option upon notice to the holder of the grantor's receipt of a bona fide offer and decision to accept it. [51]

D. The Reasons for First-Refusal Rights

Few courts and commentators have considered the motivation for first-refusal rights. Nonetheless, their main rationale clearly derives from the fact that the holder highly values the right's subject matter (for example, because of investments made in the burdened property, as in the case of a license, lease, franchise, or distributorship, or for sentimental reasons, such as a desire to keep the burdened property or business in the family) and wants the right as insurance against a future bargaining breakdown with the grantor.

A first-refusal right can have any of the following non-exclusive purposes: (1) preventing either (a) the sale of property to a person who may use it in an undesirable manner, or (b) the loss of a valuable piece of property, contract, business opportunity, or employee to a competitor; (2) ensuring compatible management of an asset; (3) ensuring continued control over a business or property; or (4) providing an opportunity to purchase a desirable property or to obtain business or a job. Which of these purposes underlie a particular first-refusal right depends, in large measure, on the nature of the parties' relationship.

For example, in the context of a close corporation, a partnership, a joint venture, or the co-ownership of property, the primary motives for a first-refusal right are to **assure compatible management**, to maintain control (or ***446** to otherwise protect the co-owners from an interloper), and to provide the current owners with an opportunity to increase their ownership interest if the stock, interest, or property becomes available for purchase at an attractive price. [52] In the context of licenses, leases, franchises, dealerships, or distributorships, the primary motives for such rights are to encourage the licensee, tenant, franchisee, dealer, or distributor to make improvements or investments that it otherwise might not make and to protect the tenant from an undesirable landlord or the licensor, franchisor or grantor from an undesirable licensee, tenant, franchisee, dealer, or distributor.[53] In the employment context, the primary motives for such rights are to prevent the loss of a valuable employee to a competitor (from the employer's viewpoint) and to provide an opportunity for advancement or a job (from the employee's view point).[54]

III. What Triggers the Holders' Right to Exercise The First-Refusal Right?

Most first-refusal rights are drafted to be triggered when the grantor decides to accept a bona fide offer for the burdened property's sale.[55] This ***447** standard formulation raises two obvious questions: First, what constitutes a bona fide offer that triggers the first-refusal right; and second, what types of transfers constitute a triggering sale?

Other questions arise when the burdened property is sold either as part of a larger property or as part of a package of properties, such as: Does the proposed transaction trigger the first-refusal right and, if so, what is the price of the burdened property and to what extent must (or can) the holder purchase all of the property that is the subject of the third-party transaction? Also, if the proposed sale does not trigger the right, what becomes of it?

*448 A. What Constitutes a Bona Fide Offer?

In Jones v. Riley,[56] the former Fort Worth Court of Civil Appeals discussed what constitutes a bona fide offer:

[I]n order for [an] offer to constitute a "bona fide offer" . . . such offer had to not only be made in good faith, but it had to also be of such a nature and in such a form that it could be, by an acceptance thereof by the offeree, caused to ripen into a valid and binding contract that could be enforced by any party to it.

To come within the meaning of the phrase "bona fide offer" the offer would have to be one that was legally valid.[57]

Courts in Texas and other jurisdictions have cited Jones' definition of bona fide offer.[58]

Courts outside Texas, without citing Jones, have similarly defined the term. For example, the Vermont Supreme Court, in the context of a first-refusal right, recently defined a bona fide offer as one made "'honestly and with a serious intent' where 'the offeror genuinely intends to bind itself to pay the offered price.'" [59]

***449** Although these definitions expressly identify only two elements --" good faith" and a "firm" offer--the case law clearly indicates that a third element exists. [60] That is, the offer must be made in an arm's length transaction resulting in a change of control over the burdened property. [61] Accordingly, a bona fide offer for purposes of triggering a first-refusal right must be (1) made in good faith; (2) a firm one; and (3) made in an arm's length transaction resulting in a change of control over the burdened property. [62]

Although the concept of good faith is an elusive one, having different meanings in different contexts, [63] a good-faith offer, in the context of a first-refusal right, is one made honestly, sincerely, and without intent to defraud ***450** or take unconscionable advantage of the grantor. [64]

To be firm, the offer must be one that is legally valid and capable of acceptance by the grantor. [65] Accordingly, preliminary negotiations do not trigger a first-refusal right:

> It is well-settled, as a matter of both law and common sense, that parties must be permitted to engage in substantive, non-binding negotiations without triggering the provisions of a right of first refusal. . . . This unremarkable proposition compels the conclusion that an unenforceable collection of negotiated terms, which together constitute neither a "contract," an "agreement," nor a "lease," cannot then be an "other arrangement" that triggers the first-refusal right. [66]

***451** In contrast, a conditional offer triggers a first-refusal right, if the condition is one that can be met. [67]

Although no court applying Texas law, either in the context of a first-refusal right or otherwise, has defined what constitutes an "arm's length transaction," courts from other jurisdictions have done so in non-first-refusal right contexts. For example, the United States Bankruptcy Court for the Northern District of Ohio has defined an "arm's length transaction" as one "characterized by the following elements: It is voluntary, i.e., without compulsion or duress, it generally takes place in an open market, and the parties are acting in their own self-interest." [68] Thus, as discussed in subpart ***452** III.B, transactions between related parties generally are not arm's length.

The fact that the purchase price in the third party's offer is above or below the property's fair market value is relevant to the offer's bona fide status depending on the surrounding circumstances. [69] For example, if the offer is from a related party and is motivated by the desire to deprive the holder of its first-refusal right or to force the holder to purchase the burdened property at an inflated price, the offer will not be found to be bona fide. [70] Similarly, when a property burdened by a first-refusal right is sold as part of a package of properties or as part of a larger parcel, and the third party either alone or with the grantor allocates a grossly disproportionate portion of the purchase price for the entire package or parcel to the burdened property, the offer likely will not be bona fide. [71]

In contrast, in an arm's length transaction involving only the burdened property, an offer above-- even one substantially above fair market value-- should be found to be bona fide even if the price was inflated to defeat the first-refusal right. As the Vermont Supreme Court recently held:

A prospective buyer may inflate the price for a parcel, or be motivated by a desire to defeat a right of first refusal, and still make a bona fide offer. As the Massachusetts Supreme Judicial Court recognized,

Inherent in a right of first refusal is the fact that a ***453** third party, not the holder of the right, will dictate the price, and the holder therefore runs the risk that the third party will agree to a price that is above market value, or that is above what the holder is willing and able to pay.

The question is whether the purchaser honestly intended to be bound by its offer. [72]

An offer below fair market value is bona fide only if the proposed transaction is an arm's length one. [73] Thus, for example, the sale of burdened property to a grantor's relative [74] or to a corporation related to, or controlled by, [75] the grantor for less than the property's fair market value likely will not be the result of a bona fide offer.

B. What Transactions Constitute a Sale?

Because most first-refusal rights are drafted to be triggered by the grantor's desire to sell the burdened property or words to similar effect (e.g., decides, elects, or intends to sell), questions arise regarding whether ***454** the right is triggered by: (1) a gift of the property; (2) the property's involuntary transfer pursuant to, for example, a foreclosure sale, a deed in lieu of foreclosure, a condemnation order, or a divorce decree; (3) the property's transfer by operation of law after the grantor's death either by will or intestate succession; (4) the property's sale or conveyance between a corporation and its shareholder(s) or between corporate affiliates; (5) a merger or other change in control of a grantor-corporation; and (6) the property's sale from one co-owner to another. Each of these types of transactions is examined below.

1. A Gift of the Burdened Property

Although no Texas case has considered the issue, courts from other jurisdictions uniformly hold that the typical first-refusal right, which is triggered by the grantor's decision to accept a bona fide offer for the property's sale, is not triggered by the giving of burdened property as a gift. [76] A sale requires the grantor to receive consideration for the property's ***455** conveyance. [77] The fact that a grantor makes the gift to receive a charitable deduction under the tax laws does not change the analysis. [78]

2. Involuntary Transfers and Transfers by Operation of Law

The majority of cases, including Texas cases, hold that involuntary transfers, pursuant to a foreclosure sale, [79] a deed in lieu of foreclosure, [80] a condemnation order, [81] a divorce decree, [82] or a transfer by operation of law ***456** after the grantor's death either by will or intestate succession [83] do not trigger the typical first-refusal right. The leading Texas case is Draper v. Gochman. [84]

In Draper, the first-refusal right gave a sublessee a preferential right to purchase the leasehold if the "lessor desires to sell or dispose of his interest" in the property. [85] After the lessor defaulted on its mortgage, the property was sold at foreclosure. [86] The Texas Supreme Court held that the first-refusal right was not triggered by the foreclosure sale because it was "involuntary." [87]

The same result was reached by the Connecticut Supreme Court in Tadros v. Middlebury Medical Center, Inc. [88] There, a warranty deed gave the holder a first-refusal right on certain real property if the grantor "form[ed] the intention" to sell the property pursuant to a bona fide offer. [89] After the property was sold at foreclosure, the holder sought to exercise its first-refusal right against the winning bidder at the foreclosure sale. [90] In holding that the foreclosure sale did not trigger the right, the Connecticut Supreme Court reasoned:
Under the plain language of the terms of the agreement in the present case, [the holder] . . . could exercise the right of first refusal only if one of two conditions were met. First, [the holder's] right would be triggered if the grantees "form[ed] the intention" of selling the premises. Second, [the holder] could exercise its right of first refusal if the grantees accepted a bona fide, written offer to purchase the property. Neither of these conditions was met in the present case.

***457** The first condition was not met because there is no evidence that [the grantor] formed the intention to sell the property. [The grantor] did not sell the property; rather, the court-appointed committee was the seller for purpose of the foreclosure action brought by [the grantor's lender]. Moreover, common sense dictates that, because [the lender] was forced to bring a foreclosure sale for nonpayment, the sale was not voluntary and [the grantor] had no intention to sell the property.

The second condition to the exercise of the right of first refusal, namely, the acceptance of a bona fide, written offer to sell the premises, also was not met. The committee did not accept a bona fide, written offer to purchase the property; rather it sold the property in accordance with a court order to conduct a foreclosure sale. Thus, because the committee did not accept any bona fide, written offer to purchase the property, the second condition to the exercise of [the holder's] right of first refusal did not occur. On the basis of the plain language of the deed retaining the right of first refusal, therefore, the right did not apply within the context of the foreclosure sale conducted by the committee. [91]

3. Transfers Between a Corporation and its Shareholders or Corporate Affiliates, Mergers, and Changes in Control of a Grantor-Corporation

Holders often claim that the terms "conveyance," "transfer," or "sale," as used in a first-refusal right, extend to any transaction resulting in the burdened property's transfer. [92] Thus, they often seek to exercise the right when: (1) the property is transferred between a corporation and its shareholder(s) or between corporate affiliates; (2) a third party purchases a controlling interest in the grantor-corporation's stock; or (3) the grantor-corporation is merged into another corporation. [93] As discussed below, these ***458** types of transactions do not trigger the typical first-refusal right.

Courts in Texas and other jurisdictions almost uniformly hold that a sale or conveyance of the burdened property between either a corporation and its shareholder(s) or corporate affiliates does not trigger the typical first-refusal right. [94] The rationale for this rule is that such a sale or conveyance is not an arm's length transaction and results in no real change in control over the burdened property.

For example, in Creque v. Texaco Antilles Ltd., [95] after all the assets of a subsidiary, including certain property burdened by a first-refusal right, were sold to another subsidiary of the same corporation for tax reasons, the holder sued, claiming that the sale triggered her first-refusal right. [96] After ***459** examining cases from other jurisdictions because none existed from either the Third Circuit or the Virgin Islands, whose law was controlling, [97] the United States Court of Appeals for the Third Circuit held that the property's sale did not trigger the right:

> A right of first refusal to purchase real property is not triggered by the mere conveyance of that property. Only when the conveyance is marked by arms' length dealing and a change in control of the property may that right be exercised. Where, as here, a corporation conveys property from one of its wholly-owned subsidiaries to another in good faith for a legitimate business purpose, there has been no bona fide third party offer sufficient to trigger a right of first refusal on the property.

> Therefore, the condition precedent to [the holder's] exercise of her right of first refusal has not yet been satisfied. [98]

Of course, if the transfer results in a true change of control of the property, the right is triggered. Thus, in Prince v. Elm Investment Co., [99] the Utah Supreme Court held that a transfer of the burdened property by the grantor-owner to a partnership that the grantor-owner did not control triggered the first-refusal right. [100]

Most courts, including Texas courts, also hold that a typical first-refusal right is not triggered by a change in control over a grantor-corporation because such a transaction does not result in the burdened property's transfer. [101] For example, in Tenneco Inc. v. Enterprise Products Co., [102] Tenneco Oil Company and four other entities owned a natural gas liquids fractionation plant. The parties' joint operating agreement contained a first-refusal right requiring each owner to offer its interest in the plant to the ***460** other owners before selling it to an unrelated third party. [103] After the parties signed the agreement, Tenneco Oil conveyed its interest in the plant to Tenneco Natural Gas Liquids Corporation, one of its wholly owned subsidiaries, and then sold all of Tenneco Natural Gas Liquids' stock to Enron Natural Gas Liquids Corporation, which, in turn, sold the stock to another Enron affiliate. [104]

The plant's other co-owners sued Tenneco Oil, claiming, among other things, that the two stock sales breached their first-refusal right. [105] Citing Galveston Terminals, Inc. v. Tenneco Oil Co., [106] the co-owners argued that the court was required to view the three transactions together in determining ***461** whether Tenneco Oil's interest in the plant had been "sold" in violation of the right. [107]

The Texas Supreme Court, in rejecting the holder's argument, "expressly disapproved" of Galveston Terminals:

Sound corporate jurisprudence requires that courts narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock. Viewing several separate transactions as a single transaction to invoke the right of first refusal compromises the law's unfavorable estimation of such restrictive provisions.

Moreover, the plain language of the Restated Operating Agreement provides that only a transfer of an ownership interest triggers the preferential right to purchase; it says nothing about a change in stockholders. The [holders] could have included a change-of-control provision in the agreements that would trigger the preferential right to purchase. None of the agreements among the parties contained such a provision. We have long held that courts will not rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained.

In holding that the sale of a corporation's stock does not trigger rights of first refusal, we join courts from other jurisdictions that have considered this issue. We also recognize the insight of commentators who have long maintained that stock sales do not invoke preemptive rights. A contrary conclusion is an unwarranted impingement on the free transfer of stock. [108]

***462** The grantor-corporation's merger into another corporation also usually does not trigger a first-refusal right because, like transfers between a corporation and its shareholder(s) or corporate affiliates, the property technically has not been sold, conveyed, or transferred. [109]

4. The Burdened Property's Inclusion in a Multi-Property Package or in the Sale of a Larger Property

In Texas, a third party's bona fide offer to purchase property burdened by a first-refusal right as part of either a package deal involving multiple properties or the sale of a larger property triggers the right irrespective of whether the grantor and third party apportion the purchase price between the burdened and unburdened properties. [110] The rationale for this rule is ***463** that to hold otherwise would allow the grantor and a prospective third-party buyer to destroy the first-refusal right. [111] In such a situation, however, the holder can neither be compelled to purchase nor require the grantor to sell any property beyond that burdened by the first-refusal right. [112]

***466** 5. The Burdened Property's Transfers Between Co-owners

Texas courts, like the courts from most other jurisdictions, hold that, absent language to the contrary in the first-refusal right, a co-owner's sale of its interest in the burdened property to another co-owner does not trigger the right because the right's purpose is to prevent the entry of outsiders. [113]

IV. What Notice Must Be Given to the Holder?

Most first-refusal rights require the grantor to give a specific notice of the third party's bona fide offer to the holder promptly. [114] The following ***467** questions arise with respect to notice: (1) What information must the notice contain when the right is silent as to its requirements and what is the holder's duty if the notice is ambiguous or unclear?; (2) If the right specifically sets forth the notice's requirements, is the holder excused from exercising the right if the notice does not comport exactly with the right's terms?; and (3) What happens to the right if the holder is given no or insufficient notice?

A. The Grantor's and Holder's Obligations when the First-Refusal Right Does Not Specify the Notice's Requirements

When the first-refusal right is silent regarding the notice's requirements, most courts, including Texas courts, hold that any method that gives the holder notice of the potential sale and that reasonably discloses the sales' terms and conditions is sufficient to trigger the right. [115] Disclosure is reasonable if the notice provides the holder with sufficient information to make an informed decision about exercising the right. [116]

Although the case law does not specify what constitutes sufficient information, clearly all of the offer's material terms and conditions must be disclosed. [117] Of course, the provision of a copy of the proposed purchase ***468** agreement or third-party offer provides reasonable notice. [118] Once the grantor reasonably discloses the terms of the third party's bona fide offer, the holder "has a subsequent duty to undertake a 'reasonable' investigation of any terms unclear to him." [119]

Thus, when the first-refusal right does not specify the notice's terms and the notice is ambiguous or unclear, the burden is on the holder to seek clarification. [120] The holder only meets its burden by formally requesting clarification, and not by mere objection to the notice. [121] "Once such request is made, the owner must respond or assume the burden of showing that the notice was reasonably accurate." [122] If the holder does not request clarification and rejects the offer, it may not contest the notice's reasonableness later. [123]

B. Substantial Performance of the Notice's Requirements Is Sufficient

When the first-refusal right specifically sets forth the notice's requirements, the holder is not excused from exercising the right if the notice fails to comport exactly with the right's terms. [124] Substantial ***469** performance by the grantor of the notice's requirements is sufficient to require action by the holder. [125] In other words, "perfect" notice is not required because the notice is merely incidental to the first-refusal right--the primary right afforded the holder is the right to purchase on the third party's terms.

Comeaux v. Suderman [126] illustrates this principle. In that case, a lease granted the lessee a first-refusal right on the leased premises, a one-acre tract used for a public fishing pier. [127] The first-refusal right required the lessor to "notify Lessee in writing of the true and complete terms and conditions of any proposed sale to a third party at least ninety (90) days prior to the date of closing of such proposed sale . . . ." [128]

The lessor eventually notified the lessee in writing of a pending $350,000 cash offer for the leased premises and some adjoining property. [129] The notice did not advise the lessee that the total acreage covered by the offer was thirty-five acres, did not provide the offer's other terms, and did not provide a copy of the third party's earnest money contract. [130]

The lessee initially advised the grantor that he would not exercise his ***470** first-refusal right because he could not afford to pay the $350,000 purchase price. [131] After the lessor sold the property to the third party, the lessee sued the lessor for the first-refusal right's breach, claiming that the right was never triggered because the notice neither offered him the opportunity to purchase only the leased premises nor provided all the terms and conditions of the third party's earnest money contract as required by the first-refusal right. [132]

In affirming the trial court's summary judgment in the lessor's favor, the Fourteenth Court of Appeals rejected the lessee's argument that he was not required to do anything until he received the purchase offer's complete terms. [133] Instead, the court held that the right terminates, if after receiving reasonable notice of the offer, the holder does not seek clarification of unclear terms and does nothing to exercise the right:

Here, [the lessor] prepared written notice to [the lessee] informing him of a pending sale of the leased premises and adjoining property for $350,000. [The lessor] also reminded [the lessee] of his right of first refusal, and invited him to contact either [the lessor] or [his] real-estate agent[] to discuss the matter further.

We find that [the lessor's] notice to [the lessee], while not a model of clarity, reasonably disclosed [the lessor's] intention to sell the leased premises and additional property to a third party for the total price of $350,000. When an owner makes a reasonable disclosure of the terms of a proposed sale to another, the holder of the right of first refusal has a duty to undertake a reasonable investigation of any terms unclear to him. A right holder who fails to do so cannot subsequently complain that he lacked sufficient information to make an informed choice about whether to purchase the property that is subject to the right of first refusal. [134]

***471** When the first-refusal right specifies the notice's requirements, the grantor need not provide the holder with additional information. For example, in Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd., [135] a "Unit Operating Agreement" for certain Permian Basin oil and gas properties (the Midland Farms Unit) contained a first-refusal right requiring each party, if it decided to sell its interest in the unit, to provide the other parties with a notice containing certain elements:

> (1) [T]he name and address of the prospective purchaser . . . (2) the purchase price or in the event of a transfer . . . of a group of properties, an allocation of the purchase price attributable to its interest in the oil and gas estate under this Agreement or in the Unit Area; (3) a legal description sufficient to identify the property and interest; and (4) all other terms of the proposed sale . . . ." [136]

Thereafter, one of the parties to the operating agreement, Altura, decided to sell all of its Permian Basin oil and gas properties through a bidding process. [137] The winning bidder, OPC, assigned a $63,000,000 value to the party's interest in the Midland Farm Unit, and Altura notified the other parties to the operating agreement, the Fasken entities, that they could purchase its interest in the unit for that amount under the first-refusal right. [138] The Fasken entities then requested Altura to provide "all documents and other information necessary to verify the basis for the $63,000,000 allocation" and stated that until they received all of the information that Altura was required to provide they would "not consider the fifteen (15) day notice period to have commenced." [139]

After Altura refused to provide the allocation information, the Fasken ***472** entities sued, seeking a declaration that Altura's notice was deficient because it did not provide the allocation information. [140] The Eighth Court of Appeals rejected the argument because "no such information was required by [the first-refusal right] for purposes of providing notice of the proposed transaction." [141]

C. No or Insufficient Notice

A first-refusal right is not triggered if the grantor fails to give notice or gives insufficient notice. [142] As held by the Eleventh Court of Appeals, "[t]he rightholder does not have a duty to act in order to exercise his preferential purchase right unless and until he receives a reasonable disclosure of the terms of the contemplated conveyance." [143] Additionally, the grantor cannot rely on the holder's constructive notice. [144] However, once the holder learns about a transaction in violation of its first-refusal right, it has a duty to act if it wants to acquire the property from a third party who purchased the burdened property with notice of the first-refusal right. [145]

However, how much time the holder has to act is unclear. A few Texas cases, in dicta, suggest that that the holder, upon learning of a sale in violation of its first-refusal right, must act within the time period specified in the right, that is, if the right gives the holder ten days after notice to accept or reject the third party's bona fide offer, the holder must act within that period. [146] Other cases, however, hold that the holder must act within a ***473** reasonable time after the holder learns about the property's sale in violation of the first-refusal right. [147] Neither set of cases, however, appears to be correct because they are inconsistent with the general rule that, absent waiver, estoppel, or laches, a non-breaching party has four years to bring an action for specific performance after a contract's breach. [148]

V. Exercising the First-Refusal Right

Typically, a first-refusal right provides that the holder must exercise it by agreeing to all the "terms and conditions" of a third party's bona fide offer. [149] Questions arise, however, regarding how long the holder has to exercise the right and when acceptance occurs. In addition, disputes often arise when: (1) the holder insists that the grantor vary the third party's offer to fit the holder's situation; (2) the offer involves unique consideration that is impossible for the holder to match; (3) the holder's security, financing, or guarantees are less secure, valuable or certain than the third party's; (4) the right's exercise will impose an adverse tax burden on the grantor; (5) the grantor insists that the holder match the price allocated to the burdened property by a third party when the property is sold as part of package deal involving multiple properties or the sale of a larger property; or (6) the contract contains a "dual option," that is, a fixed-price option and a first- ***474** refusal right, and the optionee/holder attempts to exercise the fixed-price option after receiving notice of a third-party offer for the burdened property. Each of these issues is explored below.

A. The Holder's Time to Accept and the Manner of Acceptance

Typically, the first-refusal right sets forth the time (usually a matter of days) that the holder has to exercise the right after receiving notice of the triggering offer. In such a case, the holder must exercise the right before the period expires. [150] If the right does not set forth how long the holder has to exercise it after receiving notice of the triggering offer, the holder has a reasonable time to exercise it. [151]

In the absence of an expression to the contrary in the first-refusal right or notice, the acceptance must be received to be effective. [152] That is, if the right gives the holder ten days to exercise it, the grantor must receive the acceptance within the ten-day period. [153] This is consistent with the general rule that "an acceptance of an option contract is not operative until received by the optionor." [154] Moreover, if the first-refusal right or notice specifies the mode of acceptance (for example, by signing and returning the notice letter) the holder's acceptance, like any offer, must be in that mode to create a binding contract with the grantor. [155]

*475 B. A Holder's Attempt to Vary the Triggering Offer's Terms

Because a first-refusal right ripens into an option when the triggering notice is given, [156] Texas cases almost uniformly hold that the holder's acceptance, like an optionee's acceptance, must match the triggering offer exactly except for nominal changes need to reflect the parties' identities. [157] In applying Texas law, The United States Court of Appeals for the Fifth Circuit explained this rule: Like the acceptance of any other offer, the exercise of an option, must be "unqualified, absolute, unconditional, unequivocal, unambiguous, positive, without reservation and according to the terms or conditions of the option." An unqualified acceptance guarantees that the [grantor] will receive the benefit of the bargain under which he agreed to relinquish his interests.

Where an acceptance varies from the original offer, the [grantor] stands to lose his bargain. As a result, a purported acceptance which leaves the [grantor] "as well off" as a third-party offer, but which modifies, adds to or otherwise qualifies the terms of the offer, generally constitutes a rejection of the option and a counteroffer. [158]

***476** Thus, where the first-refusal right requires the holder to match all the "terms and conditions" of the third party's bona fide offer, the holder generally is required to do just that--exactly match all the triggering offer's terms and conditions, and not only its price terms. [159] The "exact-match" requirement is founded on the basic rule of offer and acceptance that an offeree may not vary the offer's terms--that is, an acceptance must be the "mirror image" of the offer. [160]

***477** Notwithstanding the Texas cases' lip service to the "exact-matching" requirement, a question exists regarding whether an exception is present. This doubt arises from West Texas Transmission, L.P. v. Enron Corp. [161] and its progeny.

In West Texas Transmission, Valero Transmission Company had a first-refusal right to purchase Enron Corporation's half interest in a natural gas transmission pipeline. [162] Enron reached an agreement to sell its interest in the pipeline to TECO Pipeline Company, subject to the purchase's approval by the Federal Trade Commission. [163] Enron, as required by the first-refusal right, notified Valero about its agreement with TECO. [164] After Valero indicated that it would exercise its first-refusal right, the FTC advised the parties that it would only approve a sale to TECO. [165] Enron not surprisingly refused to sell its pipeline interest to Valero, [166] and Valero sued for specific performance, arguing that the FTC approval condition was an ***478** immaterial one that it did not have to match. [167]

The Fifth Circuit, applying Texas law, rejected Valero's argument. [168] In doing so, it created a "bad-faith" exception to the "exact-match" requirement: "[T]he owner of property subject to a right of first refusal remains the master of the conditions under which he will relinquish his interest, as long as those conditions are commercially reasonably, imposed in good faith, and not specifically designed to defeat the preemptive rights." [169] Thus, under West Texas Transmission, terms or conditions in a triggering offer that are either commercially unreasonable or inserted in bad faith as a "poison pill" to discourage, hinder, or prevent the holder from exercising its first-refusal right are unenforceable and may be ignored by the holder in exercising the first-refusal right. [170]

***479** The Texas Supreme Court never has considered West Texas Transmission's "bad-faith" exception to the "exact-match" requirement, and Texas intermediate appellate courts have not followed the exception uniformly. In the first case to consider the exception, Texas State Optical, Inc. v. Wiggins, [171] the First Court of Appeals adopted it:

> [I]f a [grantor] imposes a term in bad faith to defeat a [first-refusal right], the [holder] may validly exercise the [right] while at the same time rejecting the bad-faith terms. . . . [A] holder of a right of first refusal has grounds to remove specific conditions from the contract, or to extract other concessions as part of the agreement, if the offered contract contains conditions, that are not commercially reasonable, are imposed in bad faith, or are specifically designed to defeat the option holder's right. [172]

Two other Texas decisions, the Third Court of Appeals' decision in Shell v. Austin Rehearsal Complex, Inc., [173] and the Second Court of Appeals' decision in FWT, Inc. v. Haskin Wallace Mason Property ***480** Management, L.L.P., [174] also follow West Texas Transmission:

> [The] holder of right of first refusal has grounds to remove specific conditions from the contract, or extract other concessions as part of the agreement, if the offered contract contains certain conditions that are not commercially reasonable, are imposed in bad faith, or are specifically designed to defeat the [right]. The [holders] assert that we should not adopt this exception to the general rule because the Fifth Circuit [in West Texas Transmission] and the Houston Court of Appeals [in Texas State Optical] did not follow Texas law but rather created new law. We disagree. Texas courts have long recognized that the failure of the optionee to strictly comply with the options terms and conditions of the option contract may be excused when such failure is brought about by the conduct of the optionor. We believe the exception stated in Texas State Optical is reasonable and applicable to the present case." [175]

West Texas Transmission, however, has been criticized, beginning with the dissent in Texas State Optical: "I believe that the West Texas Transmission case did not follow Texas law; rather it created new law. The opinion in West Texas Transmission is long, loose, and hard to understand." [176] More significantly, in Abraham Investment Co. v. Payne Ranch, Inc., [177] the Seventh Court of Appeals soundly criticized West Texas Transmission and refused to adopt its bad-faith exception because it determined that "the Fifth Circuit created these exceptions based in large part on the law of other jurisdictions." [178] Later, the Eleventh Court of ***481** Appeals in McMillan v. Dooley, [179] citing Abraham Investment and the dissent in Texas State Optical, noted that "the factors identified in West Texas Transmission have not been unanimously embraced by Texas courts as a correct interpretation of Texas law." [180]

Assuming that Texas law recognizes a bad-faith exception to the exact-match requirement, the obvious question is: When is a term or condition in a triggering offer commercially unreasonable or imposed in bad faith to discourage, hinder, or prevent the first-refusal right's exercise? Although sparse, the case law provides some guidance. At the outset, both the motive for the allegedly commercially unreasonable or bad-faith term or condition [181] and its nature and purpose must be considered. [182] In these regards, the case law indicates that: (1) a cash price term in an arm's length transaction never can be commercially unreasonable or imposed in bad faith, even if it exceeds the property's fair market value or what the grantor knows the holder is willing or able to pay; [183] (2) a term or condition that is the result of arm's length negotiation is not commercially unreasonable or imposed in bad faith, whereas a term that is inserted at the grantor's insistence at the last minute or in response to the holder's expressed interest in exercising the first-refusal right may be commercially unreasonable; [184] ***482** and (3) a term or condition that is routinely used in business transactions of the type at issue (or that functions similarly to such a term or condition) is not commercially unreasonable or imposed in bad faith, whereas a peculiar or unusual term or condition may be. [185]

A serious question, however, exists regarding the validity of West Texas Transmission's bad-faith exception under Texas law. First, both the dissent in Texas State Optical and the Court of Appeals' decision in Abraham Investment are correct --West Texas Transmission's bad-faith exception is not based on Texas precedent, but on precedent from other jurisdictions. [186] More importantly, the Fifth Circuit, in adopting the exception, failed to recognize that Texas, unlike many other jurisdictions that apply a bad-faith exception, generally does not recognize an implied covenant of good faith and fair dealing in all contracts. [187] West Texas Transmission's good-faith ***483** exception, however, is tantamount to the imposition of such a covenant in first-refusal rights. [188]

Second, without an exact-matching requirement, the first-refusal right becomes a significant impediment to the burdened property's marketability, because it allows the holder to impede a sale to a third party simply by refusing to accept an undesirable term or condition of the triggering offer and then claiming that it is commercially unreasonable or imposed in bad faith to discourage, hinder, or prevent the right's exercise. [189] And, the threat to the property's marketability is very real because the determination of good (or bad) faith and commercial (un)reasonableness generally are fact questions that preclude summary judgment and require a full trial on the merits. [190]

***484** Third, the exception ignores the inherent nature of first-refusal rights. Inherent in such rights is the fact that the grantor and a third party, not the holder, dictate the triggering offer's terms and conditions. [191] Accordingly, the holder runs the risk that the grantor or the third party may accept, or insist upon, terms and conditions that are unacceptable to the holder.

Fourth, the exception also ignores the fact that the third party is not a party to the first-refusal right and, therefore, is not constrained by it (other than by the third party's duty not to tortiously induce the grantor to breach the right). [192] Rather, the third party is a competitor for the property and nothing precludes it from either outbidding the holder for the property or from accepting, or insisting upon, terms that are acceptable to it, but that it knows or believes are unacceptable to the holder. [193] In fact, the first-refusal right's very nature encourages a third party to offer terms and conditions ***485** that it believes will defeat the right. Imposing a duty of good faith on the grantor effectively requires a grantor to reject offers potentially undesirable to the holder, an obligation clearly exceeding the protection that first-refusal rights were created to provide. [194]

Finally, a good-faith exception to the exact-match requirement discourages thoughtful and careful negotiation and drafting of first-refusal rights in the first instance by providing a failsafe to the thoughtless or careless holder to whom the first-refusal right is purportedly material. In every circumstance in which the exception has been invoked, the dispute regarding the offensive term's or condition's commercial reasonableness or bad faith could have been avoided had the holder negotiated for one of the alternatives to first-refusal rights discussed in Part X infra or negotiated a first-refusal right that excluded the terms and conditions later alleged to be commercially unreasonable. An implied good-faith requirement should not be allowed to substitute for the holder's negotiation failures. [195]

For example, in Shell v. Austin Rehearsal Complex, Inc., the Third Court of Appeals, applying West Texas Transmission, affirmed a jury verdict finding that the lessors breached their lessee's first-refusal right for additional space in the building where the leased premises were located by including particularly onerous terms in the triggering offer in bad faith to discourage the lessee from exercising its right. [196] The dispute, however, easily could have been avoided had the lessee, instead of a first-refusal right, obtained an option or first-offer right [197] on the additional space or had the first-refusal right only required the lessee to match the triggering offer's rental provision or provided that the provisions in any lease for the additional space, other than the rental provision, be substantially the same as, or not vary materially from, those in the lessee's existing lease. [198]

David A. Bramble, Inc. v. Thomas involved a similar situation. [199] There, ***486** the Maryland Court of Appeals held that a fact question existed regarding whether a no-mining provision in the triggering offer breached a sand and gravel miner's first-refusal right. [200] Again, the dispute easily could have been avoided had the holder, instead of a first-refusal right, obtained an option or first-offer right on the burdened property or had the first-refusal right been drafted to require the holder only to match the triggering offer's price or by prohibiting any restrictions on the burdened property's use by the holder.

The inconsistency of West Texas Transmission's good-faith exception to the exact-match requirement with Texas law does not mean that the holder is without any recourse. To the contrary, once the first-refusal right ripens into an option, the holder has the same protection afforded any optionee under Texas law. [201] That is, equitable relief will be granted when the holder is prevented from exercising the right because of fraud, surprise, accident, mistake, or the grantor's improper conduct. [202]

C. Matching Unique Consideration

Sometimes, the third party will offer land, illiquid stock, or other unique consideration, such as an interest in a partnership, for the grantor's property. [203] As a general rule, the holder of a typical first-refusal right must match the offer in kind, even though a match may be plainly impossible. [204] Courts have regularly rejected the notion that the right implies a promise by the grantor not to accept an offer containing terms the holder cannot match or that a cash offer that arguably leaves the grantor as well off as the third ***487** party's offer is a match. [205]

Nonetheless, a court, in determining whether the holder's offer is an exact match, should examine the unique consideration's purpose. [206] For example, if the consideration offered for the burdened property, in whole or in part, is other property, the holder's offer of comparable, but different, property would be a match if the grantor's purpose was to obtain a rental property for income generation, but would not be a match if the grantor's purpose was to obtain a vacation or retirement property. [207] Moreover, to ***488** the extent that the grantor is under a good-faith requirement, the owner is entitled to insist on a horse, a robe, or a finger ring in lieu of cash as long as it can provide a commercially reasonable explanation for why it prefers such consideration over the holder's proposal. [208] If the holder challenges the commercial reasonableness of the third party's consideration or the grantor's good faith, the mere uniqueness of the third party's consideration "is not a sufficient explanation since, except where both offers are for immediate payment in cash, no two offers are ever identical." [209]

D. Matching Financing Terms

Often the third party will offer to pay for the property over time with the purchase price being secured by other property, [210] guaranteed by another party, [211] or contingent upon the third party's obtaining financing acceptable from a particular source. [212] By and large, courts have held the holder to such details and further have required the holder's offer to be the equivalent of the third party's offer. For example, if the third party offers a lump sum and the holder proposes installment payments with interest, no match is made and the first-refusal right terminates. [213] Similarly, if the third party offers a payment plan, security, or a third-party guarantee, the owner may ***489** reject a holder's offer that is not the equivalent in value and security. [214]

For example, in McCulloch v. M&C Beauty College, Inc., a lessee had a first-refusal right on the building it rented in Santa Ana, California. [215] Because the lessor did not have the money to make the necessary improvements to bring the building into compliance with Santa Ana's seismic code, she decided to accept an offer for its purchase for two $100,000 promissory notes, one unsecured and one secured by a different building owned by the third party that complied with the seismic code. [216] The California Court of Appeals held that the lessor properly rejected the holder's offer because its second note was secured by a building that did not meet the seismic code:

> Of course, we recognize where the prospective purchaser offers a piece of his own property as security for part of the purchase price, the holder . . . can never offer identical terms. That circumstance should not foreclose the holder . . . or his right would be illusory. But where different security is offered by each, it is not immediately apparent to the [grantor] whether the security offered is comparable. Under these unusual circumstances, the [grantor] should have a reasonable time to ascertain whether the security offered is acceptable. That decision must be governed by a reasonable man standard. [217]

E. Matching Owner's Tax Consequences

A rare scenario, but one with potentially significant consequences for the grantor, arises when the grantor's deal with the third party is tax free, but would be taxable if made with the holder. The few cases to consider the question suggest that the holder must compensate the owner for any tax burden resulting from the first-refusal right's exercise that would not have ***490** arisen if the grantor accepted the third party's offer. [218]

F. Setting the Price for the Burdened Property when It Is Sold Either as Part of a Larger Property or as Part of a Package of Properties

When a bona fide, third-party offer is made to purchase property subject to a first-refusal right as part of either a package deal involving multiple properties or the sale of a larger property, the third party may or may not apportion the purchase price between the burdened and unburdened properties. [219] If the third party does not apportion the purchase price, the burdened property's price likely will be based on the proportion of the purchase price that its fair market value bears to the fair market value of the package or the entire parcel, as determined by the trier of fact. [220] However, if the purchase price is based on a unit price, such as a per square foot or per acre price, the holder should be able to purchase the burdened property at its pro-rata share of the total purchase price. [221]

For example, in Foster v. Bullard, the holder's first-refusal right on a forty-eight acre tract of land required him to pay an amount "consistent with [a third-party] offer . . . but not less than $750.00 per acre." [222] After the grantor agreed to sell the burdened tract as part of a larger ranch for $650 per acre, the holder sought to exercise his right on the burdened tract for $750 per acre whereas the grantor insisted that he pay $3000 per acre, the tract's alleged fair market value. [223] The Third Court of Appeals, in affirming a decree of specific performance in the holder's favor at $750 per acre, rejected the grantor's argument because no evidence existed that the ***491** third party assigned a higher value to the burdened tract than to the remainder of the ranch. [224]

If the third party apportions the price between burdened and unburdened property, the holder may object to the apportionment as excessive because it exceeds the burden property's fair market value or because it is disproportionately large. [225] Most courts hold that the holder should be restricted to the allocated price absent affirmative evidence of bad faith. [226] This simply means that the price allocated to the burdened property cannot be grossly disproportionate to either the value allocated to other properties in the package or the remainder of the property in the parcel, absent evidence establishing that the burdened property is more valuable than the other properties in the package or the remaining property in the parcel. This rule is consistent with the good-faith element of a bona fide offer. [227] To be bona fide, an offer must be honest and sincere. [228] Of course, assigning a grossly disproportionate value to the burdened property is not honest or sincere because the third party would never purchase the property at the price if it were being sold individually.

*492 G. The Dual Option: Attempting to Exercise the Option After Receipt of Notice of a Bona Fide, Third-Party Offer

Oftentimes, a contract or other instrument will contain both a fixed-price option and a first-refusal right. Such provisions commonly are referred to as a dual option.[229] A question often arises regarding the provisions' interplay when a third party offers to purchase the burdened property at a price in excess of the option price and the optionee/holder, instead of exercising the first-refusal right, attempts to exercise the lower priced option.

Courts agree that the answer to the question generally turns on the provision's language.[230] The parties may provide specifically which clause takes precedence and whether the option continues or is extinguished by the third-party offer. When, however, the contract does not answer the question, a split of authority exists.[231] Some courts have held that the optionee/holder can exercise the fixed-price option without regard to the first-refusal right, whereas others have concluded that the option is forfeited or expires if it is not exercised before the optionee/holder receives notice of the third party's offer.[232] The one Texas case to consider the issue directly has held that the optionee/holder, after receiving notice of the third party's offer, must exercise the fixed-price option promptly and, if it fails to do so, the option expires.[233]

*493 VI. Termination of the First-Refusal Rights

The typical first-refusal right provides that it must be exercised within a matter of days or it terminates.[234] A number of perplexing questions arise with respect to termination: (1) Does the holder's ability to exercise the right terminate if the triggering offer expires or is revoked before the holder exercises the right?; (2) If the grantor sells property to, or enters into a contract with, a third party in violation of a first-refusal right, can the grantor and third party prevent the holder from exercising the right by rescinding the contract?; (3) What is the effect of a counteroffer by the holder in response to the grantor's notice; (4) Does the right terminate once the holder declines to exercise it?; (5) Is the right personal or assignable?; and (6) Can a right relating to a real property interest run with the land?

A. The Effect of the Triggering Offer's Expiration or Revocation

As discussed above, when the grantor notifies the holder of its decision to accept a third party's bona fide offer for the burdened property, the right matures into an irrevocable option exercisable for the period specified in the right.[235] In light of this fact and in the absence of any language in the right conditioning the holder's exercise of the right on the continued existence of the third-party offer, once triggered, the right is exercisable by the holder for the entire period of time specified in the right, even if the third party's offer terminates or is revoked. [236] Conversely, if the third party's offer ***494** terminates or is revoked before the grantor is required to give notice of the offer to the holder, the right is not triggered, and the holder cannot exercise it. [237]

Once the first-refusal right is triggered by notice, the grantor cannot change the terms and conditions on which the right can be exercised by, for example, sending a new notice. [238]

B. The Effect of the Grantor's Attempt to Rescind a Third-Party Transaction

On rare occasions, after a first-refusal right's breach, usually by a sale of the burdened property to a third party without notice to the holder, the grantor and the third party will attempt to undo the transaction by rescinding or cancelling it. The courts uniformly have rejected such efforts:

> [The grantors] maintain that they should be permitted to rescind their agreement. It has been held that after a breach of contract has given rise to a cause of action, the rights of the innocent party are not affected by an offer to perform ***495** by the party who has broken the contract. This rule should also apply to those who seek to undo their breach by rescission. It follows from this ruling that one cannot undo the legal effect of a breach by restoring the status quo as it existed prior to the breach. [239]

C. The Effect of the Holder's Rejection of the Triggering Offer or a Counteroffer

Although requests for information by holders or even attempts to negotiate alternative provisions should not constitute a rejection of the offer or waiver of the first-refusal right, only a timely exercise of the right on the terms in the triggering offer will preempt the third party's right to acquire the burdened property. [240] In addition, the right terminates if the holder timely exercises it without qualification but later refuses to execute a contract on the same terms as the triggering offer. [241]

This does not mean, however, that after the holder exercises the right, the grantor and the holder cannot agree to modify their contract. For example, in Northern Plains Alliance, L.L.C. v. Mitzel, a divorce decree gave the husband a first-refusal right to purchase a building located on land ***496** leased from a railroad. [242] By a written agreement, which provided for a March 22, 2002, closing date, the plaintiff offered to purchase the building subject to both the husband's first-refusal right and the purchaser's successful purchase of the underlying land from the railroad. [243] After being notified of the plaintiff's offer, the husband exercised the right. [244] Although he was successful in negotiating a purchase of the underlying land from the railroad, he was unable to close its purchase until after the March 10, 2002, closing date in the plaintiff's offer, and the wife agreed to extend the closing date for the building's purchase until after the husband closed on the underlying land's purchase. [245] The plaintiff then sued the husband, claiming that his failure to close the building's purchase on March 10, 2002, intentionally interfered with its contract with the wife. [246]

The North Dakota Supreme Court, in rejecting the plaintiff's argument, reasoned that "the moment the right of first refusal is exercised, the contract between [the wife] and [the plaintiff] is no longer in effect" and subject to interference and that the husband and wife thereafter were free to modify their agreement, including the closing date. [247]

Most first-refusal rights are drafted so that they apply to each sale of the burdened property during the right's term. For example, if a lease gives the tenant a first-refusal right on the leased premises during the lease's term, it does not terminate the first time the leased premises are sold, but rather applies to each sale of them during the lease's term unless the lease provides to the contrary. [248]

*497 D. The Assignability of First-Refusal Rights

In Texas, almost all contracts are assignable in the absence of a contract provision to the contrary. [249] Thus, first-refusal rights generally are assignable. [250] Moreover, when the right (or the contract containing it) expressly provides that the right is assignable, a Texas court likely will defer to that provision even if the contract is personal. [251]

In the real-estate context, not all covenants are the same. Some are personal covenants, whereas others are real covenants. The primary distinction between them "is that real covenants run with the land, binding the heirs and assigns of the covenanting parties, and personal covenants do not." [252] For a covenant to run with the land: (1) privity of estate must exist between the contracting parties; (2) the covenant must specifically bind the parties; (3) the covenant must touch and concern the land; and (4) the parties must have intended the covenant to run with the land. [253] By definition, a real covenant is enforceable against the covenantor and his or ***498** her heirs, successors, and assigns by the covenantee and his or her heirs, successors, and assigns. [254]

Although the Texas Supreme Court has never considered the question, Texas intermediate appellate courts uniformly have held that a first-refusal right can be a real covenant. [255] These cases, however, simply have assumed that the right touched and concerned the holder's land. [256]

Traditionally, to touch and concern land, a covenant must both burden the covenantor's land, that is, the grantor's land in the case of a first-refusal right, and benefit the covenantee's land, that is, the holder's land in the case of such a right. [257] Arguably, a first-refusal right at least slightly burdens the grantor's land because the grantor must comply with the right before selling it. Whether the right imposes a benefit on the holder's land is problematic, however, because a first-refusal right rarely benefits the holder's land (as ***499** opposed to the holder personally). And, if it must benefit the land, an heir, successor, or assign who does not own an interest in land cannot enforce the right against the original grantor or his or her heir, successor, or assign because by definition the right does not benefit the holder's land. [258]

Although both the leading commentator on Texas real covenants and the Third Restatement of Property have concluded that a covenant can be a real covenant even if it does not benefit the covenantee's land, [259] Texas law is unclear on the issue. [260] The only case to directly consider it in the context of a first-refusal right --First Permian, L.L.C. v. Graham--held that a right is personal and unenforceable by the holder's heirs, successors, or assigns if the right does not benefit the heir's, successor's, or assignee's land when the heir, successor, or assign seeks to enforce it. [261]

In First Permian, Graham's father, aunts, and uncles assigned their interests in certain oil and gas leases to Pan American Petroleum Corporation in consideration of a production payment and a first-refusal right on the leases. [262] Over the years, the leases were sold to a number of parties, with First Permian ultimately acquiring them. [263]

In 2002, First Permian entered into a contract to sell all of its oil and gas assets, including the Grahams' leases, to Energen Resources Company. [264] It, however, refused to allow Graham, as his father's, aunts', and uncles' heir, to exercise the assignment's first-refusal right, claiming that it had ***500** expired when the production payment was fully paid out in 1975. [265]

On appeal from an adverse judgment in Graham's favor, First Permian first argued that the trial court misconstrued the assignment because, under its express terms, the first-refusal right was expressly tied to the production payment so that the right terminated when the production payment was fully paid out. [266] Alternatively, it argued that, as the production payment had been paid out decades before, the right was unenforceable because it was a personal, rather than a real, covenant since Graham did not own a real property interest at the time of the Energen transaction. [267]

The Seventh Court of Appeals sided with First Permian on both counts. [268] It first held that, under the assignment's express language, "the [first-refusal] right was intended to exist only for so long as necessary to protect the interest of the Grahams, their heirs, successors, and assigns in the full payment for the leases." [269] Notwithstanding the dispositive nature of this holding, the court, in dicta, also concluded that even if the first-refusal right had not expired with the production payment's payout, Graham still could not have enforced it in connection with the Energen transaction because "a real covenant can only be enforced by the owners of the land the covenant was intended to benefit" and Graham owned no real property interest at the time of that transaction in light of the production payment's earlier payout. [270] In arriving at this conclusion, the court distinguished McMillan v. Dooley:

> [U]pon closer examination, the McMillan covenant had significantly more of the characteristics of a personal covenant. The facts of McMillan show that the parties, at the time of execution of the agreement in question, did not intend that Johnson [the holder] would be required to have an interest in the land to support the enforcement of his preferential right. Rather, the parties intended that Johnson have a personal right to enforce the covenant. Therefore, the covenant in McMillan does not possess all four of the requirements of a covenant running with the land, but ***501** rather constituted a personal covenant. [271]

The court's conclusion, however, involves a bit of double speak because it wholly ignores the court's earlier holding that the first-refusal right in the assignment ran with the land. [272] Moreover, the court only cited a single case in support of its holding, Davis v. Skipper, which involved a restrictive covenant, not a first-refusal right, and which stands for the wholly unremarkable proposition that when such a covenant is created to benefit other land, only the current owner of the benefitted land has standing to enforce it. [273] Further, the court in First Permian ignored the fact that a first-refusal right creates an interest in land. [274] Finally, the court's distinguishment of two other Texas cases holding that first-refusal rights run with the land, Sanchez v. Dickinson [275] and Stone v. Tigner, [276] was superficial at best. Although the court in First Permian correctly pointed out that the holder in each case owned a real property interest, it ignored the fact that nothing in either case explained how the first-refusal right benefited the holder's interest. [277]

To the extent that a first-refusal right touches and concerns the land, the determination whether the right is real or personal depends on whether the ***502** parties to the contract or other instrument creating the right intended it to run with the land. [278] If the contract or other instrument provides that the contract's covenants are binding on the parties' heirs, successors, and assigns or otherwise indicates that it is intended to run with the land, the first-refusal right is a real covenant: [279]
To determine if a preemptive right is personal to either the grantee or the grantor, other jurisdictions addressing the issue look exclusively to the language of the contract. They focus on whether the language states that the right extends to heirs or assign of either party, or otherwise indicates that

the parties intended [the right] to be binding beyond either of their lives. Absent such language, the preemptive right is deemed to be personal.[280]

VII. The Holder's Remedies for Breach of a First-Refusal Right

The typical remedy sought by a holder for the breach of a first-refusal right relating to real property is specific performance.[281] Specific ***503** performance can be obtained from the grantor if it still owns the property[282] or from a third party who purchased the property with actual or constructive notice of the first-refusal right.[283] To be entitled to specific performance, the holder must show that it: (1) was willing, ready, and able to exercise the right and purchase the burdened property on the same terms and conditions as the third party at the time the first-refusal right was breached;[284] and (2) it performed, tendered performance, or was excused from performing the contract containing the first-refusal right because the grantor repudiated the contract by, for example, selling the burdened property to a third party.[285]

***504** An action for damages against the holder typically is an alternative to an action for specific performance,[286] and the holder's only contractual remedy if a third-party purchaser did not have actual or constructive notice of the first-refusal right.[287] "The universal rule for measuring damages for the breach of a contract is just compensation for the loss or damage actually sustained."[288] The damages recoverable in a contract action are: (1) direct (or general) damages and (2) special (or consequential) damages.[289] Direct damages represent the compensation for losses that naturally and necessarily result from the contract's breach.[290] Because the loss naturally and necessarily resulting from a first-refusal right's breach is the loss of an enforceable option to purchase the burdened property, the direct damages for the breach are the same as those for an option contract's breach[291] --the difference between the property's fair market value and the price paid (or ***505** offered) by the third party.[292]

Special or consequential damages repay losses that follow naturally, but not necessarily, from the breach and, therefore, are recoverable only if the breaching party had notice or could have foreseen that the non-breaching party would suffer the loss from the contract's breach.[293] Such damages include lost profits from the burdened property's use[294] and increased financing costs.[295]

Moreover, a holder's ability to recover direct or special damages is governed by the rule that:
[A]n option holder 'need not tender performance of the contract, but he must plead and prove that he was ready, willing, and able to perform in order to recover damages.'

Courts often apply this rule to bar recovery to option holders who cannot prove that they had the financial ability to pay for the subject property at the time of the owner's breach. Likewise, an option holder who is not 'willing to perform'--one who simply would have declined to exercise his option--suffers no legal damage from breach of the option contract. [296]

***506** In addition, to its contract action, a holder also may have a cause of action against the third party for tortious interference with contract, if the third party induced the grantor to breach the first-refusal right by not giving notice of, or by giving a misleading or defective one about, the third party's offer to the holder. [297] Of course, in such a case, the third party, in addition to direct and special damages, also may be liable for exemplary damages. [298]

Finally, not only a grantor or third party may have liability to a holder, a grantor or holder also may have liability to a third party. For example, in Abraham Investment Co. v. Payne Ranch, Inc., the plaintiff was a jilted third party cash purchaser of property burdened by a first-refusal right who was deprived of the purchase when the holder exercised the right, agreeing to match the plaintiff's all cash price and other terms and conditions. [299] After exercising the right, the holder successfully negotiated with the grantor for "seller financing," and the third party sued the grantor and the holder for specific performance, [300] and the holder for, among other things, tortious interference with its purchase contract. [301]

In affirming a partial summary judgment granting the third party specific performance of its purchase contract with the grantor, the Seventh ***507** Court of Appeals relied on the fact that the contract required the holder to match its terms exactly. [302] The court also remanded the tortious interference claim to the district court for further proceedings. [303]

VIII. The Grantor and Third Party's Affirmative Defenses

A grantor or third party has two basic types of defenses to claims asserted by a holder for a first-refusal right's breach. The first type relates to the right's validity, and includes the statute of frauds and the rules against perpetuities and unreasonable restraints on alienation. [304] The second type consists of traditional contract affirmative defenses such as waiver, estoppel, laches, and limitations. Both types are discussed below.

A. The Statute of Frauds

First-refusal rights relating to real-estate transactions, [305] including real property leases for more than a year [306] and contracts to assign or transfer oil, gas, or mineral interests, [307] or the sale of goods for more than $500 [308] ***508** must satisfy the statute of frauds. [309] A first-refusal right that violates the statute of frauds, however, is not void. It merely is voidable. [310]

To satisfy the statute, the right must be in a writing signed by the grantor [311] (or his agent or legal representative) [312] that: (1) shows a binding agreement; [313] (2) identifies the parties; [314] and (3) identifies the right's subject matter. [315] Thus, for example, if the right does not describe the burdened property sufficiently, it is voidable and will not support an action for specific performance or damages for breach of contract. [316] As held by the First Court of Appeals: "The well settled rule to test the sufficiency of a description in a deed is that 'the writing must furnish within itself or by reference to some other existing writing, the means or data by which the land to be conveyed may be identified with reasonable certainty.'" [317]

***509** Because the statute of frauds requires the writing to contain the contract's essential terms, grantors and third parties on occasion have argued that the typical first-refusal right in which the price is based on a bona fide, third-party offer renders the contract partly in parol and unenforceable under the statute. [318] This argument, however, has been uniformly rejected because of the general rule that the statute is satisfied if the writing prescribes a method by which the purchase price can be determined. [319] In fact, most courts will enforce a first-refusal right even when the right contains no price or price mechanism, holding that the third party's bona fide offer sets the price and terms and conditions that the holder must accept to exercise the right. [320]

B. The Rule Against Unreasonable Restraints on Alienation

Alienation is a legal incident of property, [321] and unreasonable restraints against it are contrary to public policy and generally unenforceable. [322] ***510** First-refusal rights undeniably restrict alienability to some extent: the grantor is deprived of freedom to convey the burdened property to whomever it pleases. [323]

In Texas, as in most other jurisdictions, the typical first-refusal right (which requires the holder to match the terms and conditions of a third party's bona fide offer) is considered a reasonable alienation restraint: [324]

[The first-refusal right] involved here does not constitute an unreasonable restraint on alienation. There is no fixed price. There is no absolute option unlimited as to time. There is only the right, exercisable whenever the owner desires to sell, to purchase the property by meeting any bona fide offer. The holder of the right cannot force or prevent a sale; neither can he fix the price for a sale. In those circumstances there is not such a restraint on alienation as would violate our public policy.[325]

On the other hand, a fixed-price, first-refusal right of unlimited or long duration likely will be held to be an unreasonable restraint on alienation and void.[326]

*511 C. The Rule Against Perpetuities

The Texas Constitution prohibits perpetuities.[327] The rule against perpetuities requires that an estate or interest is valid only if vests, if at all, within the period of some life in being at the effective date of the instrument creating the future interest or twenty-one years thereafter plus a period of gestation.[328]

The Texas Supreme Court has held that the typical first-refusal right (which requires the holder to match the terms and conditions of a bona fide, third-party offer), even if unlimited in duration, does not violate the rule.[329] The Fifth Circuit most clearly explained this in Weber v. Texas Co.: The rule against perpetuities springs from considerations of public policy. The underlying reason for and purpose of the rule is to avoid fettering real property with future interests dependent upon contingencies unduly remote which isolate the property and exclude it from commerce and development for long periods of time, thus ***512** working an indirect restraint upon alienation, which is regarded at common law as a public evil.

The [first-refusal right] under consideration is within neither the purpose of nor the reason for the rule. This is not an exclusive option to the lessee to buy at a fixed price which may be exercised at some remote time beyond the limit of the rule against perpetuities, meanwhile forestalling alienation. The [first-refusal right] simply gives the lessee the prior right to take the lessor's royalty interest at the same price the lessor could secure from another purchaser whenever the lessor desires to sell. It amounts to no more than a continuing and preferred right to buy at the market price whenever the lessor desires to sell. This does not restrain free alienation by the lessor. He may sell at any time, but must afford the lessee the prior right to buy. The lessee cannot prevent a sale. His sole right is to accept or reject as a preferred purchaser when the lessor is ready to sell. The [right of first refusal] is therefore not objectionable as a perpetuity.[330]

D. Affirmative Defenses

Because first-refusal rights are contract rights, a grantor or third party sued for specific performance has the same defenses that any alleged breaching party sued for specific performance has, including laches,[331] ***513** limitations,[332] unclean hands,[333] waiver,[334] and estoppel.[335] A grantor who is sued for damages for a first-refusal right's breach has the same affirmative defenses that any allegedly breaching contracting party has, including limitations,[336] waiver,[337] and estoppel.[338]

As a first-refusal right is not triggered until the holder receives notice of the third-party offer, a question exists regarding whether the statute of limitations is tolled until the holder learns about a transaction in violation of the right--that is, whether the discovery rule applies to specific ***514** performance or damage claims arising from the right's breach.[339] Although no Texas case has considered the question of whether the discovery rule applies to such claims, for the reasons discussed below, it clearly does not.

Accrual refers to when a limitations period begins to run.[340] Because no statute defines when a contract action accrues, a court must look to the legal-injury rule.[341] Under that rule, a cause of action generally accrues when a wrongful act causes some legal injury, regardless of when the plaintiff learns of the injury and even if all resulting damages have not yet occurred.[342] A legal injury consists of any invasion of plaintiff's legally protected interests.[343] Stated another way, a cause of action generally accrues when facts come into existence authorizing a claimant to seek a judicial remedy.[344] When the defendant's conduct produces a legal injury, however slight, the cause of action accrues and the statute of limitations begins to run.[345]

The statute of limitations for a contract claim--irrespective of whether the remedy sought is specific performance or damages--is four years from the date of accrual.[346] Unless the discovery rule applies, a contract claim-- whether for damages or specific performance--accrues immediately upon breach.[347] A contract breach occurs when a party fails or refuses to do something that it promised to do in the contract.[348]

***515** The discovery rule is a limited exception to the general accrual rule.[349] Under the rule, the statute of limitations is tolled until the plaintiff knows or, in the exercise of reasonable diligence, should have known, about the wrongful act and resulting injury.[350] It applies in cases of fraud and fraudulent concealment[351] and in other cases in which "the injury's nature is inherently undiscoverable and evidence of the injury is objectively verifiable"[352] Because the discovery rule applies categorically to "bring[] predictability and consistency to the jurisprudence,"[353] "the focus is on whether a particular type of injury, rather than the plaintiff's specific injury, is discoverable."[354]

The discovery rule rarely applies to contract claims "as diligent contracting parties should generally discover any breach during the relatively long four year limitations period provided for such claims[,]"[355] and it is difficult to fathom how a breach of a first-refusal right can be inherently undiscoverable because the holder always can ask the grantor if ***516** the grantor is in compliance with the right, and because most real property transactions--the type of transactions in which most first-refusal rights are granted--are recorded.[356] As recently noted by the Fourteenth Court of Appeals:

> [D]ue diligence requires that each contracting party protect its own interests. The exercise of due diligence may require that a party ask its contract partner for information needed to verify the other's contractual performance. One who, as here, fails to ask for such information has not used due diligence. It is for this reason that the Texas Supreme Court [in Via Net v. TIG Insurance Co.[357]] has expressed concern about the use of the discovery rule in contract actions . . . .[358]

IX. Recommendations for Drafting and Exercising First-Refusal Rights

This Article sets forth default rules relating to the construction of first-refusal rights and their exercise. Because such rights are contract rights, the parties can draft around them. Set forth below are recommendations for drafting and exercising a first-refusal right so as to minimize the potential for litigation.

A. The First-Refusal Right's Triggering

> Avoid triggering the right by the grantor's subjective state of mind. The first-refusal right should identify specifically when and under what circumstances it may be exercised because much litigation centers on whether the right has been triggered. As discussed above, a first-refusal right does not grant the holder an unconditional right to purchase the property, but rather is triggered by the grantor's decision to part with the property.[359] Although this principle is stated easily in the abstract, reducing it to effective contractual language is difficult. The first-refusal right should not, as many do, say that ***517** the right is triggered when the grantor "desires" to sell the property or words of similar effect (e.g., decides, elects, or intends) because defining the trigger in terms of the grantor's subjective decision invites disputes about whether the grantor "decided" to sell. Nor should the right be triggered by the owner's receipt of an acceptable bona fide offer for the

property. Although this standard is perhaps more objective, it also leads to disputes regarding the grantor's state of mind, as well as to disputes regarding the offer's bona fides. To avoid these difficulties, the first-refusal right's trigger clause should prevent litigation about the grantor's state of mind, particularly when the burdened property has not, in fact, been sold. At the same time, it also must ensure that the holder has an adequate opportunity to exercise its right before the owner sells. As a solution, the right's triggering clause might provide that: "The grantor may not sell the burdened property to a person other than the holder without first giving written notice to the holder [a specified number of days] before such sale will occur unless the holder exercises its first-refusal right within [a specified number of days] after its receipt of the notice."

> Specifically address whether the right is triggered by involuntary transfers, transfers by gift, operation of law, mergers, transfers to affiliates, and changes in corporate ownership or control. Too often, drafters simply list a combination of legal nouns (e.g., sale, conveyance, assignment, exchange, or transfer) to describe the transactions triggering the first-refusal right. This leads to disputes regarding whether the right is triggered by the burdened property's gift, involuntary sale, transfer by operation of law, or transfer to the grantor's affiliate or owner or by the by a corporate grantor's merger or change in control.[360] One way to minimize disputes is to state expressly in the first-refusal right what types of transfers and conveyances trigger it. For example, the right can provide that the right is or is not triggered by the burdened property's gift, involuntary transfer, or transfer by operation of law, to an affiliate, by a corporate grantor's merger, or by a change in ***518** control of a corporate grantor. In fact, the right even can address changes in corporate management by providing that the right is triggered by a change in a corporate-grantor's key personnel, such as its chief executive officer or chief financial officer.

> Specifically address the holder's rights in the event the burdened property is sold as part of a larger property or as part of a package of properties. When the first-refusal right relates to property that can be sold as part of a larger property or with other properties, the right should cover such possibilities by stating whether it is triggered by such a transaction and how the purchase price will be allocated to the burdened property. For example, the right might provide that a package deal does not trigger the right or that, if triggered, the purchase price for the burdened property will be its fair market value as determined by an appraisal process.

B. Notice

> Specifically state what is required in the notice to the holder and how the holder is to exercise the right after notice. The first-refusal right should delineate how the notice is to be provided and the information that must be in the notice. One useful practice is to require the grantor to identify the prospective purchaser and to send the holder a copy of the proposed contract or third-party offer. The holder should then promptly identify needed information, specifically and in writing, and the

grantor should respond in writing promptly. Both parties should keep a record of all requests and responses.

C. Exercise and Termination

> Deal with the possibility of non-cash consideration. As discussed above, the third-party offer may provide for unique consideration, such as a land, a partnership interest, or a rare painting or involve financing terms or a guarantee. To avoid a matching controversy, the first-refusal right should cover such possibilities. For example, it might provide that it is triggered only by an all cash offer. Alternatively, it can provide that in ***519** the event of an asset exchange or other noncash consideration, the holder has the right to pay an equivalent amount of cash determined by an appraisal mechanism.

> Specifically state whether the grantor can retract or modify the notice before the holder exercises it. As discussed above, disputes can arise if the grantor attempts to retract or modify the notice before the holder exercises it. The first-refusal right should specify whether the grantor can retract or modify the notice if the third party's offer terminates or is modified.

X. Alternatives to First-Refusal Rights

The first-refusal right is a means of dealing with foreseeable, but generally indeterminate changes, in business relationships. Alternatives to a first-refusal right include the option,[361] the right of first offer, a commitment to negotiate, and a commitment to auction. These alternatives often are preferable to a first-refusal right.

A. The Right of First Offer

The first-offer right is essentially a reverse first-refusal right. Its use is demonstrated by substituting a first-offer right for the first-refusal right in the Blackacre example in Subpart II.A above: the owner of Whiteacre and Blackacre grants a first-offer right for Blackacre's purchase. That is, if the owner decides to sell Blackacre, perhaps after preliminary discussions with potential purchasers, the holder will be given notice and a specified period during which to make an offer to buy Blackacre. The owner may accept the offer or may, within a specified period, sell Blackacre to a third party at a price higher than that offered by the holder.[362]

*520 B. The Commitment to Negotiate

The commitment to negotiate, which often is seen in the employment context, specifies a period of time during which the contracting parties commit to negotiate exclusively with each other in good faith. If time is critical, the existence of an exclusive negotiating period puts pressure on the parties to reach an agreement.

C. The Commitment to Auction

The auction commitment is a sealed bid process. The holder is notified of the owner's intention to sell the property and the date when sealed bids are due. [363] The owner can set a reservation price, that is, the minimum price at which the owner will sell, and the entire process can be managed by an escrow agent to ensure fairness. On the due date, the bids are opened, and the property either will be sold to the highest bidder or retained by the owner, if no bid exceeds the reservation price.

XI. Conclusion

A boilerplate and poorly drafted first-refusal right often results in unnecessary and expensive litigation between the grantor, the holder, and a third party. Although contracting parties may not be able to anticipate every potential dispute or triggering event, careful attention to the issues discussed in this article and the alternatives to first-refusal rights may reduce costly legal battles.

Footnotes

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1 This contract right also been called, among other things:

(1)A "preferential right of purchase" or, more simply, a "preferential right." E.g., W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1561 (5th Cir. 1990) (applying Texas law). See, e.g., Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 644 (Tex. 1996); Mandell v. Mandell, 214 S.W.3d 682, 686 n.1 (Tex. App.--Houston [14th Dist.] 2007, no pet.) (noting that "a preferential right to purchase provides no greater rights than a right of first refusal").

(2)A "preemptive right to purchase" or, more simply, a "preemptive right." E.g., Turner v. Shirk, 364 N.E.2d 622, 623-24 (Ill. App. Ct. 1977); Barling v. Horn, 296 S.W.2d 94, 97 (Mo. 1956).

(3)A "first option to buy." E.g., Town of Eustis v. Stratton-Eustis Dev. Corp., 516 A.2d 951, 954 (Me. 1986); L.E. Wallach, Inc. v. Toll, 113 A.2d 258, 259 (Pa. 1955).

(4)A "first call." E.g., 11 Thompson on Real Property, Second Thomas Edition §96.03(b), at 572 (David A. Thomas ed., 2002).

(5)Even erroneously an "option." E.g., Cont'l Cablevision of New England, Inc. v. United Broad. Co., 873 F.2d 717, 722 (4th Cir. 1989) (applying Massachusetts law) ("Initially, it is clear that a right of first refusal is a type of option."); Myers v. Lovetinsky, 189 N.W.2d 571, 576 (Iowa 1971) (noting a "preferential right ...is a species of option"); David A. Bramble, Inc. v. Thomas, 914 A.2d 136, 143 (Md. 2007) ("A right of first refusal, or 'preemptive right,' is a type of option ....").

See also Cipriano v. Glen Cove Lodge No. 1458, B.P.O.E., 801 N.E.2d 388, 390-93 (N.Y. 2003) (describing different terminology applied to first-refusal rights); 3 Eric Mills Holmes, Corbin on Contracts §11.3, at 469 n.1 (rev. ed. 1996) (same) [hereinafter Corbin]; Bernard Daskal, Rights of First Refusal and the Package Deal, 22 Fordham Urb. L.J. 461, 463-64 (1994) (same). Because the emphasis should be on the word "right," "first-refusal right" is the most apt description and will be used to refer to the right in this Article.

The label applied by the parties to a contractual provision does not always mirror the provision's legal effect. Accordingly, courts and practitioners should review the provision's terms carefully. See, e.g., Briggs v. Sylvestri, 714 A.2d 56, 57 n.3 (Conn. App. Ct. 1998) (recognizing that a contractual provision labeled "option" was a first-refusal right); Berry-Iverson Co. of N.D. v. Johnson, 242 N.W.2d 126, 131 (N.D. 1976) (same); Overton v. Bengel, 139 S.W.3d 754, 757 (Tex. App.--Texarkana 2004, no pet.) (recognizing that a contractual provision labeled "right of first refusal" was an option); John D. Stump & Assocs., Inc. v. Cunningham Mem'l Park, Inc., 419 S.E.2d 699, 703 (W. Va. 1992) (recognizing that a contractual provision labeled "option" was a first-refusal right); Corbin, supra, §11.4, at 488 ("Whether a party has a right of first refusal is an issue of interpretation.").

2 E.g., W. Tex. Transmission, 907 F.2d at 1561 ("A 'right of first refusal' ...permits the rightholder to purchase the subject property, once the owner chooses to sell, on the terms and conditions specified in the contract granting the right."); Tenneco, 925 S.W.2d at 644 ("A right of first refusal ...empowers its holder with a preferential right to purchase the subject property on the same terms offered by or to a bona fide purchaser."); Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 532 (Tex. App.--Waco 2008, pet. denied) ("Generally, a preferential right [of first refusal] requires the owner of the subject property to offer the property first to the holder on the same terms and conditions offered by a third party."); Nat'l Adver. Co. v. Potter, No. 01-06-01042-CV, 2008 WL 920338, at *3 (Tex. App.--Houston [1st Dist.] Apr. 3, 2008, no pet.) ("A right of first refusal has a generally well established meaning in the business world as giving the holder of such a right the first opportunity to purchase property from the owner on the same terms offered by any third party."); Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 524 (Tex. App.--Amarillo 1998, pet. denied) (same); Restatement (Third) of Prop.: Servitudes §3.4 cmt. f (2000) ("Rights of first refusal are used to give the seller and others the right to purchase the property when the buyer decides to sell."); Corbin, supra note 1, §11.3, at 468-69 (noting that first-refusal rights "create a right, a contractual right, to 'preempt' another"); Black's Law Dictionary 1439 (9th ed. 2009) (defining a first-refusal right as "[a] potential buyer's contractual right to meet the terms of a third party's higher offer").

3 Hereinafter, the three parties will be referred to as the "grantor," the "holder," and the "third party." Most first-refusal rights relate to real property interests. See sources cited infra note 16. Consequently, this Article, in discussing such rights, generally assumes that they relate to such interests and deals with issues relevant to rights relating to real property interests, such as covenants running with the land and the rules against perpetuities and against unreasonable restraints on alienation. Nonetheless, this Article's analyses generally are applicable irrespective of the type of interest burdened by the right.

4 See sources cited supra note 2.

5 E.g., W. Tex. Transmission, 907 F.2d at 1562 ("The holder of the first-refusal right cannot compel a recalcitrant owner to convey the property."); Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd., 225 S.W.3d 577, 589 (Tex. App.--El Paso 2005, pet. denied) ("Until the [first-refusal] right is triggered, its holder may not compel the property owner to sell."); Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 187 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.) ("An owner does not have to sell and, until the owner decides to sell, there is nothing to exercise ....").

6 E.g., W. Tex. Transmission, 907 F.2d at 1562 (holding that a first-refusal right "guarantees that the rightholder will receive notice when the owner intends to sell the property, information about the terms and conditions of that sale, and a reasonable period within which to accept or reject the offer"); Prince v. Elm Inv. Co., 649 P.2d 820, 826 (Utah 1982) (stating that a grantor desiring to sell property burdened by right of first refusal "must ...give [the holder] notice of the third party's offer and his intention to accept that offer"); Raymond v. Steen, 882 P.2d 852, 854 n.3 (Wyo. 1994) ("The grantor must give some notice to the [holder] of his intention to sell and the terms of the offer." (quoting Thomas J. Goger, Annotation, 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. 203, 206 (1976))); Corbin, supra note 1, §11.3, at 471 ("The owner must notify the holder of the owner's receipt of the third-party offer and the decision to accept it." (citation omitted)).

7 Durrett Dev., Inc. v. Gulf Coast Concrete, L.L.C., No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at *10 (Tex. App.--Houston [14th Dist.] Aug. 27, 2009, no. pet. h.) ("A right of first refusal may ripen into an option contract upon the occurrence of a triggering event, as specified in the parties' agreement."); FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P., 301 S.W.3d 787, 793 (Tex. App.--Fort Worth 2009, pet. filed) ("[W]hen the property owner gives notice of his intent to sell, the preferential right matures or 'ripens' into an enforceable option."); Collins v. Collins, No. 13-07-240-CV, 2009 WL 620470, at *1 (Tex. App.--Corpus Christi Mar. 12, 2009, pet. denied) ("When the property owner gives notice of his intention to sell, the right of first refusal matures or 'ripens' into to [sic] an enforceable option. The terms of the option are formed by the provisions granting the preferential right to purchase and the terms and conditions of the third party offer ...."); Navasota Res., 249 S.W.3d at 533 (same); Comeaux v. Suderman, 93 S.W.3d 215, 220 (Tex. App.--Houston [14th Dist.] 2002, no pet.) ("A right of first refusal ripens into an option when the owner elects to sell.").

8 Durrett Dev., 2009 Tex. App. LEXIS 6787, at *12 ("[B]efore the option created by the right of first refusal [can] ripen into an enforceable contract, [the holder has] to manifest unambiguous acceptance of the option strictly in accordance with the terms of the agreement."); FWT, 301 S.W.3d at 794 ("When the rightholder gives notice of his acceptance of the offer, a contract between the rightholder and the property owner is created."); Navasota Res., 249 S.W.3d at 533 ("When the rightholder gives notice of his intent to accept the offer and exercise his option, a binding contract is created between the rightholder and the property owner."); City of Brownsville v. Golden Spread Elec. Coop., Inc., 192 S.W.3d 876, 880 (Tex. App.--Dallas 2006, pet. denied) (same); Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 525 (Tex. App.--Amarillo 1998, pet. denied) ("[W]hen the rightholder gives notice of ...acceptance of the offer, a sale contract is created, even if it is stipulated in the agreement that a subsequent formal contract be executed.").

9 W. Tex. Transmission, 907 F.2d at 1562; see Glick v. Chocorua Forestlands L.P., 949 A.2d 693, 699-700 (N.H. 2008) ("In all cases, interpretation [of a first-refusal right] requires knowledge of the entire context, context of facts as well as context of words."); St. George's Dragons, L.P. v. Newport Real Estate Group, L.L.C., 971 A.2d 1087, 1098 (N.J. Super. Ct. App. Div. 2009).

10 E.g., Corbin, supra note 1, §11.3, at 469; Daskal, supra note 1, at 461.

11 See, e.g., Hyperbaric Oxygen Therapy Sys., Inc. v. St. Joseph Med. Ctr. of Fort Wayne, Inc., 683 N.E.2d 243, 245 (Ind. Ct. App. 1997) (involving a first-refusal right to sell medical equipment).

12 See, e.g., Ellwest Stereo Theaters, Inc. v. Davilla, 436 So. 2d 1285, 1286 n.1 (La. Ct. App. 1983) (involving a first-refusal right to lease commercial property); Nat'l Adver. Co. v. Potter, No. 01-06-01042-CV, 2008 WL 920338, at *3 (Tex. App.--Houston [1st Dist.] Apr. 3, 2008, no pet.) (involving a first-refusal right to renew a ground lease for billboards); Shell v. Austin Rehearsal Complex, Inc., No. 03-97-00411-CV, 1998 WL 476728, at *1 n.1 (Tex. App.--Austin Aug. 13 1998, no pet.) (involving a first-refusal right to lease additional space in a building).

13 See, e.g., Simulnet E. Assocs. v. Ramada Hotel Operating Co., No. 95-16339, 1997 U.S. App. LEXIS 19952, at *7 n.1 (9th Cir. 1997) (unpublished table decision) (involving a first-refusal right for satellite television services); Burzynski v. Travers, 636 F. Supp. 109, 111 (E.D.N.Y. 1986) (involving a television director's first-refusal right to direct a film).

14 See, e.g., Russell v. District of Columbia, 747 F. Supp. 72, 79 (D.D.C. 1990) (involving a hospital employee's first-refusal right on other District of Columbia jobs), aff'd, 984 F.2d 1225 (D.C. Cir. 1993).

15 See, e.g., ABC v. Wolf, 430 N.Y.S.2d 275, 277 (App. Div. 1980) (involving a television station's first-refusal right to a sportscaster's services), aff'd, 420 N.E.2d 363 (N.Y. 1981).

16 E.g., Miller v. LeSea Broad., Inc., 87 F.3d 224, 226 (7th Cir. 1996) (applying Wisconsin law) ("[I]t is in the real-estate market that rights of first refusal are chiefly found ...."); Burzynski, 636 F. Supp. at 112 (pointing out that first-refusal rights frequently appear in contracts, "particularly those pertaining to real estate"); Hyperbaric Oxygen Therapy Sys., 683 N.E.2d at 248 ("The right of first refusal is typically associated with the purchase of property, where the holder has the right to purchase the property on the same terms that the seller is willing to accept from a third party."); Unlimited Equip. Lines, Inc. v. Graphic Arts Ctr., Inc., 889 S.W.2d 926, 932 (Mo. Ct. App. 1994) ("Although a first right of refusal is most frequently given in connection with the sale or lease of real estate, it can be given with respect to any matter which is subject to contract." (citations omitted)); Corbin, supra note 1, §11.3, at 469 (noting that first-refusal rights "customarily, but not exclusively, arise in real property transactions"); Daskal, supra note 1, at 461 n.4 ("A majority of cases addressing contracts containing a right of first refusal concern real property.").

17 See, e.g., A.G.E., Inc. v. Buford, 105 S.W.3d 667, 670 (Tex. App.--Austin 2003, pet. denied); 6500 Cedar Springs, L.P. v. Collector Antique, Inc., No. 05-98-00386, 2000 WL 1176586, at *1 (Tex. App.--Dallas Aug. 21, 2000, no pet.); Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 522 (Tex. App.--Amarillo 1998, pet. denied); Riley v. Campeau Homes, Inc., 808 S.W.2d 184, 186 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.); Holland v. Fleming, 728 S.W.2d 820, 821 (Tex. App.--Houston [1st Dist.] 1987, writ ref'd n.r.e.); Dunlap-Swain Tire Co. v. Simons, 450 S.W.2d 378, 379 (Tex. Civ. App.--Dallas 1970, writ ref'd n.r.e.); Mecom v. Gallagher, 213 S.W.2d 304, 304 (Tex. Civ. App.--El Paso 1947, no writ); Stone v. Tigner, 165 S.W.2d 124, 125 (Tex. Civ. App.--Galveston 1942, writ ref'd).

18 See, e.g., Starr v. Wilson, 11 So. 3d 846, 853 (Ala. Civ. App. 2008) (involving a first-refusal right in a sales contract); Tadros v. Middlebury Med. Ctr., Inc., 820 A.2d 230, 235 (Conn. 2003) (involving a first-refusal right in a deed); Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 523 (Tex. 1982) (same); FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P., 301 S.W.3d 787, 790 (Tex. App.--Fort Worth 2009, pet. filed) (involving a first-refusal right in a deed); Sanchez v. Dickinson, 551 S.W.2d 481, 482 (Tex. Civ. App.--San Antonio 1977, no writ) (involving a first-refusal right in a sales contract); Raymond v. Steen, 882 P.2d 852, 853 (Wyo. 1994) (same).

19 See, e.g., Weber v. Tex. Co., 83 F.2d 807, 807 (5th Cir. 1936) (applying Texas law) (involving a first-refusal right in oil and gas lease); Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 528 (Tex. App.--Waco 2008, pet. denied) (involving a first-refusal right in a joint-operating agreement); El Paso Prod. Co. v. Geomet, Inc., 228 S.W.3d 178, 181 (Tex. App.--Dallas 2007, pet. denied) (involving a first-refusal right in a farm-in agreement and an overriding royalty); Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd., 225 S.W.3d 577, 581 (Tex. App.--El Paso 2005, pet. denied) (same); McMillan v. Dooley, 144 S.W.3d 159, 165 (Tex. App.-- Eastland 2004, pet. denied) (involving a first-refusal right in oil and gas leases); Questa Energy Corp. v. Vantage Point Energy, Inc., 887 S.W.2d 217, 220 (Tex. App.--Amarillo 1994, writ denied) (involving a first-refusal right in a joint-operating agreement); Perritt Co. v. Mitchell, 663 S.W.2d 696, 697 (Tex. App.--Fort Worth 1983, writ ref'd n.r.e.) (involving a first-refusal right in an oil and gas lease); Martin v. Lott, 482 S.W.2d 917, 919 (Tex. Civ. App.--Dallas 1972, no writ) (involving a first-refusal right in an overriding royalty); Sibley v. Hill, 331 S.W.2d 227, 228 (Tex. Civ. App.-- El Paso 1960, no writ) (involving a first-refusal right in a joint-operating agreement). See also Harlan Abright, Preferential Right Provisions and Their Applicability to Oil and Gas Instruments, 32 Sw. L.J. 803, 803 (1979) ("An important, yet often overlooked, provision commonly included in oil and gas instruments, particularly, joint operating agreements, farm-out agreements, and unit operating agreements, is one providing for a preferential right to purchase." (citations omitted)); Terry I. Cross, The Ties that Bind: Preemptive Rights and Restraints on Alienation that Commonly Burden Oil and Gas Properties, 5 Tex. Wesleyan L. Rev. 193, 194-95 (1999) (noting that first-refusal rights "are encountered frequently enough to be an issue in virtually every sale of producing properties" and that they "are typically found in joint operating agreements, occasionally in other agreements affecting joint ownership arrangements, and even in oil and gas leases"); Harry M. Reasoner, Preferential Purchase Rights in Oil and Gas Instruments, 46 Tex. L. Rev. 57, 57 (1968) (pointing out that first-refusal rights "have long been utilized in the oil business and are contained in the forms suggested in all the standard works on oil and gas").

In fact, four of the five law review articles published by Texas law schools discussing first-refusal rights relate to their use in oil and gas instruments. See generally Albright, supra; Gary B. Conine, Property Provisions of the Operating Agreement--Interpretation, Validity, and Enforceability, 19 Tex. Tech. L. Rev. 1263 (1988); Cross, supra; Reasoner, supra. The fifth relates to first-refusal rights in shareholder agreements. See generally Carrie A. Platt, Note, Right of First Refusal in Involuntary Sales and Transfers by Operation of Law, 48 Baylor L. Rev. 1197 (1996).

20 E.g., In re Adelphia Commc'ns Corp., 368 B.R. 348, 350 (Bankr. S.D.N.Y. 2007) (applying New York law); Cavaliere v. Dunkin' Brands, Inc., No. CV-084009199, 2008 WL 1971463, at *2 (Conn. Super. Ct. Apr. 23, 2008); Schupack v. McDonald's Sys., Inc., 264 N.W.2d 827, 829 (Neb. 1978); Tex. State Optical, Inc. v. Wiggins, 882 S.W.2d 8, 9 n.2 (Tex. App.--Houston [1st Dist.] 1994, writ denied); see also Peter Siviglia, Rights of First Refusal, 66 N.Y. St. B.J. 56, 56 (1994) (providing a sample first-refusal right "dealing with a new product under a distributorship agreement").

21 E.g., Seessel Holdings, Inc. v. Fleming Cos., 949 F. Supp. 572, 574 (W.D. Tenn. 1996); Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 493 (Tex. App.--Houston [14th Dist.] 1992, writ denied); Consol. Bearing & Supply Co. v. First Nat'l Bank, 720 S.W.2d 647, 650 (Tex. App.--Amarillo 1986, no writ); Platt, supra note 19, at 1197.

Article 2.22 §D(1) of the Texas Business Corporation Act expressly authorizes first-refusal rights in shareholder agreements provided that they are conspicuously noted on the stock certificate. Tex. Bus. Corp. Act Ann. art. 2.22 §D (Vernon Supp. 2003).

22 E.g., Russell v. District of Columbia, 747 F. Supp. 72, 79 (D.D.C. 1990), aff'd, 984 F.2d 1255 (D.C. Cir. 1993) (unpublished table decision); ABC v. Wolf, 430 N.Y.S.2d 275, 277 (App. Div. 1980), aff'd, 420 N.E.2d 363 (N.Y. 1981).

23 E.g., Union Pac. Res. Group, Inc. v. Rhône-Poulenc, Inc., 247 F.3d 574, 579 n.8 (5th Cir. 2001) (involving a first-refusal right in a limited partnership agreement); Robertson v. Murphy, 510 So. 2d 180, 181 (Ala. 1987) (involving a first-refusal right in a real-estate partnership); Park Plaza, Ltd. v. Pietz, 239 Cal. Rptr. 51, 52 (Ct. App. 1987) (involving a first-refusal right in a joint venture agreement to develop a resort hotel), overruled on other grounds by Moncharsh v. Heily & Blasé, 832 P.2d 899 (Cal. 1992); Lede v. Aycock, 630 S.W.2d 669, 670 (Tex. App.--Houston [14th Dist.] 1981, writ denied) (involving a first-refusal right in a real-estate partnership).

24 E.g., Burzynski v. Travers, 636 F. Supp. 109, 111 (E.D.N.Y. 1986).

25 E.g., CBS, Inc. v. Capital City Commc'ns, Inc., 448 A.2d 48, 51-52 (Pa. Super. Ct. 1982).

26 E.g., W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1556 (5th Cir. 1990).

27 E.g., Gleason v. Norwest Mortgage, Inc., 243 F.3d 130, 139 (3d Cir. 2001).

28 E.g., Miller v. LeSea Broad., Inc., 87 F.3d 224, 225 (7th Cir. 1996).

29 E.g., In re Adelphia Commc'ns Corp., 368 B.R. 348, 351 (Bankr. S.D.N.Y. 2007); Radio Webs, Inc. v. Tele-Media Corp. 292 S.E.2d 712, 715 (Ga. 1982).

30 E.g., Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 641-42 (Tex. 1996).

31 E.g., Koch Indus., Inc. v. Sun Co., 918 F.2d 1203, 1209-10 (5th Cir. 1990).

32 E.g., Citgo Petroleum Corp. v. Occidental Chem. Corp., No. 99-CV-032-H, 2001 U.S. Dist. LEXIS 25808, at *6 (N.D. Okla. Jan. 22, 2001).

33 E.g., City of Brownsville v. Golden Spread Elec. Coop., Inc., 192 S.W.3d 876, 878 (Tex. App.--Dallas 2006, pet. denied).

34 E.g., USA Cable v. World Wrestling Fed'n Entm't, Inc., 766 A.2d 462, 465 (Del. 2000); CBS, Inc. v. Capital City Commc'n, Inc., 448 A.2d 48, 51-52 (Pa. Super. Ct. 1982).

35 E.g., Guggenheim v. Comm'r, 46 T.C. 559, 564 (1966).

36 See infra Parts VII.A-B (discussing the applicability of the rules against perpetuities and unreasonable restraints on alienation).

37 David I. Walker, Rethinking Rights of First Refusal, 5 Stan. J.L. Bus. & Fin. 1, 12 (1999).

38 See generally, e.g., Seessel Holdings, Inc. v. Fleming Cos., 949 F. Supp. 572 (W.D. Tenn. 1996) (involving a shareholders' agreement giving the corporation a first-refusal right on shareholders' stock transfers); Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 493 (Tex. App.--Houston [14th Dist.] 1992, writ denied) (involving corporate bylaws giving the corporation a first-refusal right on shareholders' stock transfers); Consol. Bearing & Supply Co. v. First Nat'l Bank, 720 S.W.2d 647, 650 (Tex. App.--Amarillo 1986, no writ) (same); Earthman's, Inc. v. Earthman, 526 S.W.2d 192, 202 (Tex. Civ. App.--Houston [1st Dist.] 1975, no writ) (involving articles of incorporation giving the corporation a first-refusal right on shareholders' stock transfers).

39 See, e.g., cases cited supra note 23 and note 35.

40 See infra Part VI.D.

41 See Mcgargel Willbrand & Co., L.L.C. v. FAMPAT, L.P., 210 S.W.3d 205, 210 (Mo. Ct. App. 2006) (holding that a right of first refusal in a property interest that runs with the land is assigned or expires with a lease).

42 Walker, supra note 37, at 13.

43 See, e.g., Inglehart v. Phillips, 383 So. 2d 610, 615-16 (Fla. 1980) (involving a fixed-price, first-refusal right); Brooks v. Terteling, 688 P.2d 1167, 1168 (Idaho 1984) (same); Cole v. Peters, 3 S.W.3d 846, 849 (Mo. Ct. App. 1999) (same); Stratman v. Sheetz, 573 N.E.2d 776, 777 (Ohio Ct. App. 1989) (same); Long v. Wayble, 618 P.2d 22, 24, 25 (Or. Ct. App. 1980) (same); Abraham Inv. Co.

v. Payne Ranch, Inc., 968 S.W.2d 518, 525 (Tex. App.--Amarillo 1998, pet. denied) (same); Foster v. Bullard, 496 S.W.2d 724, 726-27 (Tex. Civ. App.--Amarillo 1973, writ ref'd n.r.e.) (involving a first-refusal right for the purchase of land at the greater of a bona fide offer's per acre price or $750 per acre). See also H.G. Fabric Disc., Inc. v. Pomerantz, 515 N.Y.S.2d 823, 824 (App. Div. 1987) (involving a first-refusal right for the lesser of a bona fide offer's price or $200,000).

44 See, e.g., Drayson v. Wolff, 661 N.E.2d 486, 492 (Ill. App. Ct. 1996); Lorentzen v. Smith, 5 P.3d 1082, 1083 (N.M. 2000); Lin Broad. Corp. v. Metromedia, Inc., 542 N.E.2d 629, 630-31 (N.Y. 1989); Collins v. Collins, No. 13-07-240-CV, 2009 WL 620470, at *3 (Tex. App.--Corpus Christi Mar. 12, 2009, pet. denied); Rolfe v. King, No. 05-03-00357-CV, 2004 WL 784626, at *1 (Tex. App.--Dallas Mar. 29, 2004, no pet.).

45 Fixed-price first-refusal rights often are unreasonable restraints on alienation. See infra Part VIII.B.

46 To be enforceable, a first-refusal right must be supported by consideration. Trianco v. IBM Corp., 583 F. Supp. 2d 649, 664-65 (E.D. Pa. 2008) (applying New York law), aff'd, 2009 U.S. App. LEXIS 22213 (3d Cir. Sept. 17, 2009); Starr v. Wilson, 11 So. 3d 846, 853 (Ala. Civ. App. 2008); Wyatt v. Pezzin, 589 S.E.2d 250, 252 (Ga. Ct. App. 2003); Abraham Inv., 968 S.W.2d at 524; Martin v. Lott, 482 S.W.2d 917, 920 (Tex. Civ. App.--Dallas 1972, no writ); Corbin, supra note 1, §11.3, at 470. When the right is incidental to a larger transaction, such as a lease, a franchise, a land sale, or an employment contract, the consideration supporting the larger transaction (for example, the rental payments, the franchise fees, the purchase price, or the employment) will support the first-refusal right. Trianco, 583 F. Supp. 2d at 664-65; Starr, 11 So. 3d at 853; cf. 14 Tex. Jur. 3d Contracts §95 (2006) ("If an option is contained in a contract that is itself supported by a sufficient consideration, no other independent consideration is necessary."); Corbin, supra note 1, §11.7, at 512 (same).

Increasingly, first-refusal rights are created by statute. E.g., Petroleum Marketing Practices Act, 15 U.S.C. §2802 (2006) (giving a distributor a first-refusal right on its gas station when an oil company terminates its distributorship); D.C. Code Ann. §§42-3404.02-.08. (LexisNexis 2001) (giving residential tenant first-refusal right on leased property when the lessor sells it); Fla. Stat. Ann. §723.071 (West 2000) (providing homeowners' association with first-refusal right on a mobile park when the owner sells it); Iowa Code Ann. §654.16 (West 1995) (providing farm owner with first-refusal right on the farm's foreclosure sale).

47 E.g., Winberg v. Cimfel, 532 N.W.2d 35, 39 (Neb. 1995) (holding that a first-refusal right "is not a true option"); Procter v. Foxmeyer Drug Co., 884 S.W.2d 853, 859 (Tex. App.--Dallas 1994, no writ) (recognizing a distinction between an option and a first-refusal right); Corbin, supra note 1, §11.3, at 468-69 ("A right of first refusal is not an option contract."); Bryan A. Garner, A Dictionary of Modern Legal Usage 623 (2d ed.1995) (noting that an option and a first-refusal right "are usefully distinguished in the law of contract").

48 "Option contracts have two components: (1)an underlying contract that is not binding until accepted; and (2)a covenant to hold open to the optionee the opportunity to accept." Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 188 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.); accord Durrett Dev., Inc. v. Gulf Coast Concrete, L.L.C., No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at *10 (Tex. App.--Houston [14th Dist.] Aug. 27, 2009, no. pet. h.); Hott v. Pearcy/Christon, Inc., 663 S.W.2d 851, 853 (Tex. App.--Dallas 1983, writ ref'd n.r.e.). Generally, an option's price is fixed or is objectively determinable by reference to a public market or an appraisal.

49 See Durrett Dev., 2009 Tex. App. LEXIS 6787, at *10.

50 Id.; Comeaux v. Suderman, 93 S.W.3d 215, 219 (Tex. App.-- Houston [14th District] 2002, no pet.); Procter, 884 S.W.2d at 859; Riley, 808 S.W.2d at 187; Sanchez v. Dickinson, 551 S.W.2d 481, 484, 485-86 (Tex. Civ. App.--San Antonio 1977, no writ).

51 See cases cited supra note 8.

52 Questa Energy Corp. v. Vantage Point Energy, Inc., 887 S.W.2d 217, 222 (Tex. App.--Amarillo 1994, writ denied) (discussing the purpose of first-refusal rights in joint operating agreements); Williams Gas Processing-Wamsutter Co. v. Union Pac. Res. Co., 25 P.3d 1064, 1067 n.2 (Wyo. 2001) (same); Restatement (Third) of Prop.: Servitudes §3.4 cmt. f (2000) (noting that a right of first refusal "may be used to control entry into a development"); Frank E. Easterbrook et al., The Economic Structure of Corporate Law §7.02 (1991) (discussing the purpose of first-refusal rights in shareholder agreements); Abright, supra note 19, at 804-05 (discussing the purpose of first-refusal rights in oil and gas instruments); Conine, supra note 19, at 1317 (same); Cross, supra note 19, at 194 (same); Joseph Jude Norton, Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas, 39 Sw. L.J. 781, 804 (1985) (discussing the purpose of first-refusal rights in shareholder agreements.

53 E.g., Reef v. Friday Afternoon, Inc., 73 B.R. 940, 944 (Bankr. D. Mass. 1987) (applying Massachusetts law); Meyer v. Warner, 448 P.2d 394, 397 (Ariz. 1968); Lehn's Court Mgmt. L.L.C. v. My Mouna Inc., 837 A.2d 504, 507 (Pa. Super. Ct. 2003); Nw. Television Club, Inc. v. Gross Seattle, Inc., 612 P.2d 422, 425 (Wash. Ct. App. 1980), aff'd in part, rev'd in part on other grounds, 634 P.2d 837 (Wash. 1981), modified on other grounds, 640 P.2d 710 (Wash. 1982).

54 See Russel v. District of Columbia, 747 F. Supp. 72, 81 (D.D.C. 1990).

55 E.g., W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1562 (5th Cir. 1990) (applying Texas law) (involving a first-refusal right in an ownership agreement for a natural gas transmission pipeline); Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 644 (Tex. 1996) (involving a first-refusal right in an operating agreement for a natural gas liquids fractionation plant); First Permian, L.L.C. v. Graham, 212 S.W.3d 368, 369 (Tex. App.-- Amarillo 2006, pet. denied) (involving a first-refusal right in an oil and gas lease assignment); Shell v. Austin Rehearsal Complex, Inc., No. 03-97-00411-CV, 1998 WL 476728, at *1 n.1 (Tex. App.--Austin Aug. 13, 1998, no pet.) (involving a first-refusal right in a commercial lease); Tex. State Optical, Inc. v. Wiggins, 882 S.W.2d 8, 9 n.2 (Tex. App.--Houston [1st Dist.] 1994, no writ) (involving a first-refusal right in a franchise agreement); Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 186 (Tex. App.-- Houston [14th Dist.] 1991, writ dism'd by agr.) (involving a first-refusal right in a condominium lease); Stone v. Tigner, 165 S.W.2d 124, 125 (Tex. Civ. App.--Galveston 1942, writ ref'd) (involving a first-refusal right in a grazing lease).

An example of the typical first-refusal right is found in Riley v. Campeau Homes (Tex.), Inc.:

[I]f at any time during the term of this Lease ...Landlord should receive a bona fide offer from any person ...to purchase in whole or in part, the Leased Premises, the Landlord shall send Tenant a copy of the proposed Contract and notify Tenant of its intentions to accept the same. Tenant shall have the right within fifteen (15) days of receipt of the proposed Contract to accept the terms of the Contract in writing and within forty-five (45) days thereafter to purchase the above described property ...for the gross purchase price and on the price and terms specified in said Contract.

808 S.W.2d at 186 (emphasis omitted). See also Tex. State Optical, 882 S.W.2d at 9 n.2 ("In the event of a bona fide offer in writing by a Third Party to purchase the office, and [the franchisee] desires to sell on the basis of such bona fide offer, [the franchisee] agrees to first offer the [franchisor] the same opportunity to purchase on the same terms.").

Not all first-refusal rights, however, are tied to a bona fide offer. For example, the first-refusal right in the American Association of Petroleum Landmen's standard operating agreement, Form 610-1989, provides, in pertinent part:

Should any party desire to sell all or any part of its interests under this agreement, or its rights and interests in the Contract Area, it shall promptly give written notice to the other parties, with full information concerning its proposed disposition ....The other parties shall than have an optional prior right, for a period of ten days (10) after the notice is delivered, to purchase for the stated consideration on the same terms and conditions the interest which the other party proposes to sell ....

Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 529-30 & n.1 (Tex. App.--Waco 2008, pet. denied).

56 471 S.W.2d 650 (Tex. Civ. App.--Fort Worth 1971, writ ref'd n.r.e.).

57 Id. at 658-59.

58 E.g., Ray v. Lancaster Inv. Group, No. 05-93-01857-CV, 1994 Tex. App. LEXIS 4045, at *14 (Tex. App.--Dallas Aug. 5, 1994, no writ) (not designated for publication) (involving offer to purchase a building); Baldwin v. New, 736 S.W.2d 148, 152 (Tex. App.--Dallas 1987, writ denied) (same); Lede v. Aycock, 630 S.W.2d 669, 674 (Tex. App.--Houston [14th Dist.] 1981, writ denied) (involving a first-refusal right); DCM Inv. Corp. v. Pinecrest Inv. Co., 34 P.3d 785, 788-89 (Utah 2001) (same).

59 Rappaport v. Banfield, 924 A.2d 72, 79 (Vt. 2007) (quoting Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 963 (Mass. 2004)). See also Hartzheim v. Valley Land & Cattle Co., 62 Cal. Rptr. 3d 815, 823 (Ct. App. 2007) ("Generally speaking, it is the concurrence of both an arms' length transaction and change in control of the property that characterizes a bona fide sale."); Schroeder v. Duenke, 265 S.W.3d 843, 848 (Mo. Ct. App. 2008) ("Under Missouri law, a bona fide offer is one that is made in good faith, by a person with good judgment and acquainted with the value of the property, with sufficient ability to pay in cash, and based upon fair market value."); Story v. Wood, 569 N.Y.S.2d 487, 489 (App. Div. 1991) (defining a "good-faith offer" in the context of a first-refusal right as "(1)a genuine outside offer rather than one contrived in concert with the seller solely for the purpose of extracting a more favorable price from the holder ...and (2)an offer which [the grantor] honestly is willing to accept" (citations omitted)); Shepherd v. Davis, 574 S.E.2d 514, 521 (Va. 2003) (holding that the term "bona fide" for purposes of a third-party offer for property burdened by a first-refusal right "is defined as '[m]ade in good faith; without fraud or deceit'" (quoting Black's Law Dictionary 168 (7th ed. 1999)).

60 See infra note 61.

61 See, e.g., Creque v. Texaco Antilles Ltd., 409 F.3d 150, 155 (3d Cir. 2005) (applying Virgin Islands law) ("A right of first refusal to purchase real property is not triggered by the mere conveyance of that property. Only when the conveyance is marked by arms' length dealing and a change in control of the property may that right be exercised."); Kroehnke v. Zimmerman, 467 P.2d 265, 267 (Colo. 1970) (requiring an arm's length transaction to trigger first-refusal right); Fina Oil & Chem. Co. v. Amoco Prod. Co., 673 So. 2d 668, 672 (La. Ct. App. 1996) (holding that, in determining whether an offer is "bona fide," "courts have generally placed emphasis on either the presence or absence of arm's length dealing between the owner of the burdened interest and the third-party transferee or upon the effect of the conveyance as placing the property beyond the reach of the holder of the right"); LaRose Mkt., Inc. v. Sylvan Ctr., Inc., 530 N.W.2d 505, 509 (Mich. Ct. App. 1995) ("For purposes of a right of first refusal a 'sale' occurs upon the transfer (a)for value (b)of a significant interest in the subject property (c)to a stranger to the lease, (d)who thereby gains substantial control over the leased property." (quoting Prince v. Elm Inv. Co., 649 P.2d 820, 823 (Utah 1982))); Belliveau v. O'Coin, 557 A.2d 75, 78 (R.I. 1989) (requiring an arm's length transaction to trigger a first-refusal right); DCM Inv. Corp., 34 P.3d at 789 (Utah 2001) (holding that "[o]ther factors may assist the court in determining the bona fides of an offer, including (1)the relationship of the parties (e.g., whether the parties have competing interests), (2)whether the transaction was made under duress, (3)whether the transaction occurred in the open market, (4)whether the offer approximates fair market value, and (5)whether there are any elements of fraud or misrepresentation involved"); McGuire v. Lowery, 2 P.3d 527, 532 (Wyo. 2000) (same); Abright, supra note 19, at 811 (explaining that in deciding whether a sale has occurred, most courts "place[] emphasis on ...the presence or absence of arm's length dealing between the owner of the burdened interest and the third party transferee").

62 See supra note 61.

63 E.g., Restatement (Second) of Contracts §205 cmt. a (1979) ("The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context."); Roger Brown et al., Good Faith in Contracts: Concept and Context 3 (1999) ("[G]ood faith is an elusive idea, taking on different meanings and emphases as we move from one context to another ....").

64 Tex. Bus. & Com. Code Ann. §1.201(20) (Vernon 2009) (Uniform Commercial Code defining "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing"); Preston Nat'l Bank v. Schutze, 2004 Bankr. LEXIS 584, at *6-7 (Bankr. N.D. Tex. May 4, 2004) (mem. op.) (defining "bona fide" as "made in good faith, without fraud or deceit .... Sincere, genuine." (quoting Black's Law Dictionary 168 (7th ed. 1999))); Story, 569 N.Y.S.2d at 489; Cent. Am. Aviation Servs., S.A. v. Bell Helicopter Textron, Inc., No. 02-06-126-CV, 2007 Tex. App. LEXIS 1469, at *18 (Tex. App.--Fort Worth Mar. 1, 2007, no pet.) (defining "good faith" as "a state of mind consisting in (1)honesty in belief or purpose ...or (4)absence of intent to defraud or to seek unconscionable advantage" (quoting Black's Law Dictionary 713 (8th ed. 2004))); Bennett v. Computer Assocs. Int'l, Inc., 932 S.W.2d 197, 202 (Tex. App.--Amarillo 1996, writ denied) (defining "good faith" as "honesty in fact"); MBank Grand Prairie v. State, 737 S.W.2d 424, 427 (Tex. App.--Fort Worth 1987, no writ) (defining "bona fide" as "[i]n or with good faith; ...without deceit or fraud" (quoting Black's Law Dictionary 160 (5th ed. 1979))); Shepherd, 574 S.E.2d at 521.

An offer by a third party, who clearly lacks the financial ability to consummate the transaction is not bona fide. E.g., Smith v. Bertram, 603 N.W.2d 568, 573-74 (Iowa 1999); Imperial Refineries Corp. v. Morrissey, 199 N.W.2d 872, 878 (Iowa 1963); Shell Oil Co. v. Kapler, 50 N.W.2d 707, 712-13 (Minn. 1951). For example, in Imperial Refineries Corp. v. Morrissey, the Iowa Supreme Court affirmed a jury verdict that a priest's offer to purchase property from his mother for $60,000 was not a bona fide one that triggered a first-refusal right because the priest's salary was $1,000 per year and he had no appreciable assets. 119 N.W.2d at 713; see also LDC-728 Milwaukee, L.L.C. v. Raettig, 727 N.W.2d 82, 86-87 (Wis. Ct. App. 2006) (holding that the holder breached a first-refusal right when he exercised it knowing that he could not purchase the burdened property).

65 See Black's Law Dictionary 1113 (8th ed. 2004) (defining "offer").

66 Citgo Petroleum Corp. v. Occidental Chem. Corp., No. 99-CV-032-H, 2001 U.S. Dist. LEXIS 25808, at *11 (N.D. Okla. Jan. 22, 2001); accord Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 645 (Tex. 1996) ("Preliminary negotiations between offerors and potential purchasers do not trigger preemptive rights.").

A prospective purchaser may not want to expend the time and effort to negotiate and draft a purchase contract or offer only to be preempted by the holder of a first-refusal right. Thus, early in the negotiation process, the third party may demand that the grantor ask the holder to waive its first-refusal right as a condition to the third party making a purchase offer or submitting a purchase contract. Courts generally hold that such a request is insufficient to trigger the right. E.g., Wyman v. Leikam, 480 P.2d 97, 99 (Wyo. 1971). Moreover, on occasion, a lessor-grantor will receive an offer to purchase leased property conditioned on the termination of the holder-tenant's lease. The general rule is that, absent language to the contrary in the lease or the first-refusal right, the tenant-holder's rejection of the third party's offer does not terminate the tenant-holder's lease. E.g., Sexton v. Nelson, 39 Cal. Rptr. 407, 416 (Ct. App. 1964); Eaton v. Fisk, 584 N.Y.S.2d 280, 281 (App. Div. 1992); Marshall v. Summers, 934 S.W.2d 647, 650-53 (Tenn. Ct. App. 1996); Golden Spread Oil, Inc. v. Am. Petrofina Co., 431 S.W.2d 50, 52-53 (Tex. Civ. App.--Amarillo 1968, writ ref'd n.r.e.).

67 Mucci v. Brockton Bocce Club, Inc., 472 N.E.2d 966, 968 (Mass. App. Ct. 1985); Story, 569 N.Y.S.2d at 489; Nw. Television Club, Inc. v. Gross Seattle, Inc., 634 P.2d 837, 840 (Wash. 1981), modified on other grounds, 640 P.2d 710 (Wash. 1982); see also Weisser v. Wal-Mart Real Estate Bus. Trust, No. 04-15, 2005 U.S. Dist. LEXIS 11185, at *22-27 (E.D. Ky. June 8, 2005) (involving conditional third-party offer); H.G. Fabric Disc., Inc. v. Pomerantz, 515 N.Y.S.2d 823, 825 (App. Div. 1987) (holding that third party's offer to purchase building conditioned on building being vacant did not trigger first-refusal right because the building was occupied and, therefore, the condition was impossible to meet).

68 Cedar View, Ltd. v. Colpetzer, No. 5:05-CV-00782, 2006 WL 456482, at *2 (N.D. Ohio Feb. 24, 2006) (applying Ohio law); accord Crème Mfg. Co. v. United States, 492 F.2d 515, 520 (5th Cir. 1974) (holding that "[t]o be at arm's length under [the manufacturer's excise statute] a transaction must be between parties with adverse economic interests. Each party to the transaction must be in a position to distinguish his economic interest from that of the other party and, where they conflict, always choose that to his individual benefit." (citation and internal quotation omitted)).

An arm's length transaction necessarily assumes that the parties have relatively equal bargaining power. E.g., Allegheny Ludlum Corp. v. United States, 367 F.3d 1339, 1348 (Fed. Cir. 2004) (A negotiation or transaction is conducted at "arm's length" if it is "between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power"); Black's Law Dictionary 123 (9th ed. 2009) (same).

A grantor seeking to avoid triggering a first-refusal right, however, should not rely too heavily on a "relatively-equal-bargaining-power" requirement. The Texas Supreme Court recently suggested that an actionable disparity in bargaining power exists only "when one party has no choice but to accept an agreement limiting the liability of another party....[A] bargain is not negated because one party may have been in a more advantageous bargaining position. Rather, we consider whether a contract results in unfair surprise or oppression." In re Lyon Fin. Servs., Inc., 257 S.W.3d 228, 232-33 (Tex. 2008) (rejecting argument that a forum selection clause was unenforceable because, among other reasons, it was contained in a lease offered to the plaintiff on a "take-it-or-leave-it basis").

69 E.g., Raytheon Co. v. Rheem Mfg. Co., 322 F.2d 173, 178-80 (9th Cir. 1963) (applying California law); Schroeder v. Duenke, 265 S.W.3d 843, 848 (Mo. Ct. App. 2008); DCM Inv. Corp. v. Pinecrest Inv. Co., 34 P.3d 785, 789 (Utah 2001).

70 E.g., Raytheon, 322 F.2d at 178-82 (holding that an offer by a grantor's parent corporation to buy certain manufacturing equipment burdened by a first-refusal right solely to force the holder to purchase it at an inflated price was not a bona fide offer); Story, 569 N.Y.S.2d at 489 (noting that for an offer to be a "good-faith offer" in the context of a first-refusal right it must, among other things, be "a genuine outside offer rather than one contrived in concert with the seller solely for the purpose of extracting a more favorable purchase price from the holder").

71 See infra Part V.F.

72 Rappaport, 924 A.2d at 79 (citations omitted) (quoting Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 963 (Mass. 2004)); see Shepherd v. Davis, 574 S.E.2d 514, 521 (Va. 2003) (rejecting argument that a third party's offer was not bona fide because its terms "were designed to make it unreasonable for him to purchase the [p]roperty").

73 While not much authority exists, Texas cases suggest that, in an arm's length transaction, virtually any sale for value will trigger the first-refusal right. E.g., Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 525 (Tex. 1982) (holding that first-refusal right was triggered by an oil and gas lease); Mandell v. Mandell, 214 S.W.3d 682, 688 (Tex. App.--Houston [14th Dist.] 2007, no pet.) (holding that first-refusal right was triggered by the transfer of burdened property to attorney in part payment of a contingent fee); A.G.E., Inc. v. Buford, 105 S.W.3d 667, 671, 673 (Tex. App.--Austin 2003, pet. denied) (same); IMCO Oil & Gas Co. v. Mitchell Energy Corp., 911 S.W.2d 916, 921 (Tex. App.--Fort Worth 1995, no writ) (holding that first-refusal right was triggered by the grant of an overriding royalty); Sanchez v. Dickinson, 551 S.W.2d 481, 487 (Tex. Civ. App.--San Antonio 1977, no writ) (holding that first-refusal right was triggered by an oil and gas lease). See also Barela v. Locer, 708 P.2d 307, 310 (N.M. 1985) (holding that first-refusal right was triggered by an oil and gas lease).

74 E.g., Issacson v. First Sec. Bank of Utah, 511 P.2d 269, 272 (Idaho 1973) (holding that the burdened property's conveyance to the grantor's son for a third of its fair market value was more in the nature of a gift than a sale and, therefore, did not trigger the first-

refusal right); Schroeder v. Duenke, 265 S.W.3d 843, 848 (Mo. Ct. App. 2008) (holding that a fact issue existed regarding whether parent's sale of family's house to son for less than its appraised value was "bona fide").

75 See infra notes 95-98.

76 E.g., Cottrell v. Beard, 9 S.W.3d 568, 571 (Ark. 2000) (holding that a gift of the burdened property did not trigger a first-refusal right conditioned on the property's sale); Hartzheim v. Valley Land & Cattle Co., 62 Cal. Rptr. 3d 815, 822 (Ct. App. 2007) ("A gift of the property to third parties ...does not trigger a typical right of first refusal."); Webster v. Ocean Reef Cmty. Ass'n, 944 So. 2d 367, 370 (Fla. Dist. Ct. App. 2008) ("Were we to construe 'sale' or 'purchase' to include [the grantor's] transfer and her residential trust's transfer, the [holder] would have a right of first refusal to acquire the residence for nothing, nada, zero. We will not construe the documents to produce an absurd result."); Issacson, 511 P.2d at 272 (holding that a first-refusal right was not triggered by grantor's gift of the burdened property to his son); Rucker Props., L.L.C. v. Friday, 204 P.3d 671, 676 (Kan. Ct. App. 2009) ("[B]ecause the conveyance ...was an intra-family gift and not a sale and no ownership was transferred to anyone outside of the lease agreement, the right of first refusal was not triggered."); Minton v. Crawford, 719 So. 2d 743, 745-46 (La. Ct. App. 1998) (holding that the burdened property's gift to the grantor's children did not trigger a first-refusal right); Park Station Ltd. P'ship, L.L.L.P. v. Bosse, 835 A.2d 646, 653 (Md. 2003) (holding that burdened property's gift to a charitable fund did not trigger a first-refusal right); Schroeder, 265 S.W.3d at 847 ("Under Missouri law, a transfer of property by gift from one family member to another does not trigger a right of first refusal."); Mericle v. Wolf, 562 A.2d 364, 368 (Pa. Super. Ct. 1989) (holding that burden property's gift to a hospital did not trigger a first-refusal right); Bennett v. Dove, 277 S.E.2d 617, 619 (W. Va. 1981) ("The [first-refusal right holders] used the words 'desires to sell' to express their intent. 'Sell' is commonly and ordinarily understood to mean an act of giving up property for money that the buyer either pays or promises to pay in the future, and we must conclude that [the grantor] did not sell the property when he gave it to two of his children." (citation omitted)); Dewey v. Dewey, 33 P.3d 1143, 1149 (Wyo. 2001) ("[A] 'sale' in the context of a right of first refusal is a 'transfer for value of a significant interest in the subject property to a stranger who thereby gains substantial [ownership or] control over the subject property."' (quoting Prince v. Elm Inv. Co., 649 P.2d 820, 823 (Utah 1982))). But see Warden v. Taylor, 333 A.2d 922, 923 (Pa. 1975) (holding that a gift of property triggered first-refusal right because the right was conditioned on either the "sale" or "conveyance" of the property).

77 Tex. Bus. & Com. Code Ann. §2.106(1) (Vernon 2009) (defining "sale" for purposes of the Uniform Commercial Code as the "passing of title from the seller to the buyer for a price"); Cottrell, 9 S.W.3d at 571 ("A sale is a contract by which one party transfers the ownership of property to another for a price."); Park Station, 835 A.2d at 652 ("[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."'); Cherokee Water Co., 641 S.W.2d at 525 ("The term 'sale,' when used in a property context, is commonly understood to mean any conveyance of an estate for money or money's worth."); Galveston Terminals, Inc. v. Tenneco Oil Co., 904 S.W.2d 787, 791 (Tex. App.--Houston [1st Dist.] 1995) ("The term 'sale,' when used in a property context means a conveyance of an estate for money...."), set aside without reference to the merits, 922 S.W.2d 549 (Tex. 1996), disapproved on other grounds, Tenneco, Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 645 (Tex. 1996); Mark D. Christiansen, Preferential Right of Purchase Issues in Oil and Gas Property Sales, 10 Nat. Resources & Env't 35, 35-36 (1996) (recognizing rights of first refusal often refer to a sale, which commonly means a conveyance for money).

78 E.g., Park Station, 835 A.2d at 651 (finding a collateral benefit to the grantor in the form of a tax deduction was not sufficient to make the burdened property's conveyance a sale).

79 E.g., Draper v. Gochman, 400 S.W.2d 545, 548 (Tex. 1966); Consol. Bearing & Supply Co. v. First Nat'l Bank, 720 S.W.2d 647, 650-51 (Tex. App.--Amarillo 1986, no writ); see also Tadros v. Middlebury Med. Ctr., Inc., 820 A.2d 230, 235 (Conn. 2003); Equitable Trust Co. v. O'Neill, 420 A.2d 1196, 1200-01 (Del. Super. Ct. 1980); Henderson v. Millis, 373 N.W.2d 497, 503 (Iowa 1985); Corbin, supra note 1, §11.3, at 476 n.17.

80 E.g., Pellandini v. Valadao, 7 Cal. Rptr. 3d 413, 416 (Ct. App. 2003).

81 E.g., Campbell v. Alger, 83 Cal. Rptr. 2d 696, 700 (Ct. App. 1999); Kowalsky v. Familia, 336 N.Y.S.2d 37, 43 (Sup. Ct. 1972); see Corbin, supra note 1, §11.3, at 476 n.17 ("A holder ...cannot exercise the right against a buyer at a forced sale ...because the condition precedent (the third-party offer and decision to accept it) has not occurred.").

82 E.g., Earthman's, Inc. v. Earthman, 526 S.W.2d 192, 202 (Tex. Civ. App.--Houston [1st Dist.] 1975, no writ). But see Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 494 (Tex. App.--Houston [14th Dist.] 1992, writ denied) (holding that a first-refusal right was triggered by stock's transfer on the shareholder's death because the shareholders' agreement applied to any "disposition" of the stock).

83 E.g., Brooks v. Terteling, 688 P.2d 1167, 1169 (Idaho 1984).

84 400 S.W.2d 545 (Tex. 1966).

85 Id. at 545.

86 Id.

87 Id. at 547. The Texas Supreme Court in Draper also held that the execution of a deed of trust for the burdened property did not constitute a sale because it did not pass title to the property. Rather, title remained in the grantor, and the deed of trust's beneficiary merely had a lien. Id.; accord Consol. Bearing & Supply Co. v. First Nat'l Bank, 720 S.W.2d 647, 650-51 (Tex. App.--Amarillo 1986, no writ) (holding that neither a pledge of stock nor its subsequent sale at foreclosure triggered a first-refusal right).

88 820 A.2d 230 (Conn. 2003).

89 Id. at 233.

90 Id. at 233-34.

91 Id. at 235; accord Earthman, 526 S.W.2d at 202 (recognizing, a first-refusal right generally "is inapplicable to a transfer occurring as a result of an involuntary sale or by operation of law unless by specific provision in the restriction it is made applicable").

92 See infra notes 94-109.

93 See infra notes 94-109.

94 Questa Energy Corp. v. Vantage Point Energy, Inc., 887 S.W.2d 217, 222 (Tex. App.--Amarillo 1994, writ denied) (holding that burdened property's transfer by subsidiary to parent corporation did not trigger first-refusal right); see, e.g., Evans v. SC Southfield Twelve Assocs., 208 Fed. Appx. 403, 408-09 (6th Cir. 2006) (applying Michigan law) (holding that burdened property's transfer by grantors to limited liability company owned by them did not trigger first-refusal right); see also Creque v. Texaco Antilles Ltd., 409 F.3d 150, 155 (3d Cir. 2005) (applying Virgin Islands law) (holding that burdened property's transfer from one subsidiary to another for tax reasons did not trigger first-refusal right); Roeland v. Trucano, 214 P.3d 343, 352 (Alaska 2009) (concluding that burdened property's transfer from grantor corporation to limited liability company owned by the corporation's shareholder did not trigger first-refusal right); Hartzheim v. Valley Land & Cattle Co., 62 Cal. Rptr. 3d 815, 824 (Ct. App. 2007) (holding that the burdened property's sale to the grantors' children and grandchildren for tax and estate planning purposes did not trigger first-refusal right); Kroehnke v. Zimmerman, 467 P.2d 265, 267 (Colo. 1970) (holding that burdened property's conveyance by individual grantors to their wholly-owned corporation did not trigger first-refusal right); Wallasey Tenants Ass'n v. Varner, 892 A.2d 1135, 1141 (D.C. 2006) (holding that burdened property's transfer to grantor's limited liability company for liability and estate planning reasons did not trigger first-refusal right); Sand v. London & Co., 121 A.2d 559, 562 (N.J. Super. Ct. App. Div. 1956) (holding that burdened property's conveyance by grantor-corporation to an affiliate did not trigger first-refusal right); Lehn's Court Mgmt. LLC v. My Mouna Inc., 837 A.2d 504, 511 (Pa. Super. Ct. 2003) (holding that burdened property's conveyance from limited liability company to the company's owner did not trigger first-refusal right); Belliveau v. O'Coin, 557 A.2d 75, 78-79 (R.I. 1989) (holding that burdened property's conveyance by an individual grantor to her wholly-owned corporation did not trigger first-refusal right); McGuire v. Lowery, 2 P.3d 527, 532 (Wyo. 2000) (holding that the burdened property's conveyance by individual grantors to their wholly-owned corporation did not trigger first-refusal right). But see Auntie Ruth's Furry Friends' Home Away from Home, Ltd. v. GCC Prop. Mgmt., LLC, No. A08-1602, 2009 Minn. App. Unpub. LEXIS 1030, at *10-11 (Minn. Ct. App. Sept. 15, 2009) (alternatively holding that the burdened property's transfer from grantor corporation to another corporation owned by the same shareholders triggered first-refusal right and expressly rejecting contrary "foreign case law").

95 409 F.3d 150 (3d Cir. 2005).

96 Id. at 151-52.

97 Id. at 153-54.

98 Id. at 155 (citations and footnote omitted). See also supra note 94. Of course, after the transfer the holder's first-refusal right remains intact. E.g., Creque, 409 F.3d at 155 n.4; Lehn's Court Mgmt., 837 A.2d at 511.

99 649 P.2d 820 (Utah 1982).

100 Id. at 823; accord Auntie Ruth's Furry Friends' Home Away from Home, Ltd. v. GCC Prop. Mgmt., LLC, No. A08-1602, 2009 Minn. App. Unpub. LEXIS 1030, at *10-11 (Minn. Ct. App. Sept. 15, 2009) (alternatively holding that burdened property's transfer from grantor corporation to another corporation with a new shareholder triggered a first-refusal right).

101 See, e.g., Creque, 409 F.3d at 155.

102 925 S.W.2d 640 (Tex. 1996).

103 Id. at 642.

104 Id.

105 The co-owners did not claim that Tenneco Oil's conveyance of its interest in the plant to Tenneco Natural Gas Liquids breached the first-refusal right because the right expressly exempted transfers to affiliates from its scope. Id. at 642.

106 904 S.W.2d 787 (Tex. App.--Houston [1st Dist.] 1995), set aside without reference to the merits, 922 S.W.2d 549 (Tex. 1996). In Galveston Terminals, Galveston Terminals' predecessor sold certain land to Tenneco Oil Company. The sales contract granted Galveston Terminals a first-refusal right on the tract if Tenneco "elect[ed] to sell all or any part of [it] ...." Id. at 788. Thereafter, Tenneco transferred thousands of acres of land to a newly formed subsidiary, including the tract burdened by the first-refusal right, and sold all of the subsidiary's stock to Fina Oil & Chemical Company, which dissolved the subsidiary and distributed the subsidiary's assets to itself. Id. at 789-90.

After learning about the transactions, Galveston Terminals sued Tenneco and Fina for breach of its first-refusal right, claiming that the substance of the transaction constituted a "sale" within the right's meaning. Id. at 789. In reversing a summary judgment in Tenneco's and Fina's favor, the First Court of Appeals was willing to review the transaction's "substance over form," holding that a fact issue existed with respect to Galveston Terminals' re-characterization of the three-step transaction as a sale of the burdened property:

The character of a legal transaction depends on the intent and purpose of the parties. A contract regarding real property is construed as a whole. The courts will look to each and all of the parts of the written instrument, as well as to surrounding circumstances, to determine the intent and purpose of the parties. In order to ascertain the intention of the parties, all of the instruments that are shown to be component parts of a single transaction should be read together.

Defendants argue that, viewed in isolation, none of the three transactions involved here constitutes a "sale." However, the summary judgment evidence viewed as a whole presents a picture of a transaction that, in a roundabout way, accomplished just what a direct sale would have ....

Id. at 791.

107 Tenneco, 925 S.W.2d at 645 (noting that the co-owners argued that the court "should look to the parties' intent to determine the nature of the transaction").

108 Id. at 646 (citations omitted); accord Cruising World, Inc. v. Westermeyer, 351 So. 2d 371, 373 (Fla. Dist. Ct. App. 1977); K.C.S., Ltd. v. E. Main St. Land Dev. Corp., 388 A.2d 181, 183 (Md. Ct. Spec. App. 1978); LaRose Mkt., Inc. v. Sylvan Ctr., Inc., 530 N.W.2d 505, 508 (Mich. Ct. App. 1995); Torrey Delivery, Inc. v. Chautauqua Truck Sales & Serv., Inc., 366 N.Y.S.2d 506, 510 (App. Div. 1975); Albright, supra note 19, at 811-12; Conine, supra note 19, at 1320 & n.231; Reasoner, supra note 19, at 72. But see Williams Gas Processing-Wamsutter Co. v. Union Pac. Res. Co., 25 P.3d 1064, 1073 (Wyo. 2001) (refusing to follow Tenneco). Of course, Tenneco's holding seems to provide grantors with an avoidance technique. That is, they can transfer the burdened property to a wholly-owned subsidiary and then sell the subsidiary's stock to a third party without triggering the right. And, it appears, based on Tenneco's express disapproval of Galveston Terminals' reasoning and its holding that first-refusal rights should be narrowly construed, that, in Texas, a grantor can create a new subsidiary for purposes of such a transaction. Tenneco, 925 S.W.2d at 646.

109 E.g., Engel v. Teleprompter Corp., 703 F.2d 127, 134-35 (5th Cir. 1983) (applying Texas law).

110 McMillan v. Dooley, 144 S.W.3d 159, 179 (Tex. App.--Eastland 2004, pet. denied) (holding that a first-refusal right was triggered by the burdened oil and gas lease's sale with two other leases); Comeaux v. Suderman, 93 S.W.3d 215, 221 n.3 (Tex. App.--Houston [14th District] 2002, no pet.) (holding that a first-refusal right was triggered by the burdened one acre tract's sale as part of a larger tract); Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 189 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.) (holding that a first-refusal right was triggered by a burdened condominium unit's sale with twenty-four other units); Foster v. Bullard, 496

S.W.2d 724, 736-37 (Tex. Civ. App.--Austin 1973, writ ref'd n.r.e.) (holding that a first-refusal right was triggered by the burdened forty-eight acre tract's sale as part of the sale of a 2487 acre ranch); see Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 535 (Tex. App.--Waco 2008, pet. denied) (holding that a first-refusal right was triggered by the burdened working interest's sale with stock in the grantor's parent corporation and the entry of a thirteen county, area of mutual interest agreement). Also noteworthy is FWT, Inc. v. Haskin Wallace Mason Property Management, L.L.P., 301 S.W.3d 787 (Tex. App.--Fort Worth 2009, pet. filed), which involved the question of whether, in a multi-asset sale, the holder has to purchase both the burdened property and other assets. There, the court assumed that the offer triggered the right because the holder abandoned its summary judgment argument that the right had not been triggered. Id. at 794 n.4.

Some courts from other jurisdictions follow the Texas rule. See, e.g., Anderson v. Armour & Co., 473 P.2d 84, 89 (Kan. 1970); Berry-Inverson Co. of N.D., Inc. v. Johnson, 242 N.W.2d 126, 134 (N.D. 1976); Boyd & Mahoney v. Chevron U.S.A., 614 A.2d 1191, 1194 (Pa. Super. Ct. 1992); Wilber Lime Prods., Inc. v. Ahrndt, 673 N.W.2d 339, 343 (Wis. Ct. App. 2003). See generally Daskal, supra note 1, at 480-84 (discussing cases)

Courts rejecting the Texas rule mostly hold that a third party's bona fide offer to purchase the burdened property as part of either a package deal involving multiple properties or a larger property does not trigger the first-refusal right because "an attempt to sell the whole may not be taken as a manifestation of an intention or desire on the part of the owner to sell the smaller optioned part ...." Chapman v. Mut. Life Ins. Co., 800 P.2d 1147, 1151 (Wyo. 1990); accord Gyurkey v. Babler, 651 P.2d 928, 933 (Idaho 1982); Guaclides v. Kruse, 170 A.2d 488, 493 (N.J. Super. Ct. App. Div. 1961); Daskal, supra note 1, at 475-77. These courts, however, will enjoin the grantor from including the burdened property in the transaction or, if the sale has been consummated, order a purchaser with notice of the first-refusal right to re-convey the burdened property to the grantor. In either event, the court also will enjoin the grantor from selling the burdened property until after it receives an offer for only the burdened property and complies with the right. E.g., Chapman, 800 P.2d at 1152; Gyurkey, 651 P.2d at 934; Daskal, supra note 1, at 475-76.

111 Navasota Res., 249 S.W.3d at 534; Comeaux, 93 S.W.3d at 221 n.3; see Riley, 808 S.W.2d at 189.

112 Pantry Pride Enters., Inc. v. Stop & Shop, Cos., 806 F.2d 1227, 1229 (4th Cir. 1986) (applying Virginia law) ("Every court to consider the matter has held that a [grantor] cannot force an option holder to buy more property than that covered by the first-refusal provision."); Navasota Res., 249 S.W.3d at 537 (holding that the holder of a first-refusal right on an oil and gas interest was not required to purchase the interest and stock in the grantor's parent or to enter into a thirteen county area of mutual interest agreement); McMillan, 144 S.W.3d at 179 (concluding that the holder of a first-refusal right on an oil and gas lease was not required to purchase two other oil and gas leases); Comeaux, 93 S.W.3d at 221 n.3 (holding that the holder of a first-refusal right on a one acre tract was not required to purchase adjoining land); Hinds v. Madison, 424 S.W.2d 61, 64 (Tex. Civ. App.--San Antonio 1967, writ ref'd n.r.e.) ("We do not see how in any way [the holder's] option or preference right to purchase a portion of the property sought to be sold can be enlarged to cover other lands owned by lessors, or can in any manner cover anything except the property actually subject to the [first-refusal right]."); Daskal, supra note 1, at 480 ("[A]mong the courts that conclude the right of first refusal is activated by a package deal, most hold that the rightholder is entitled to specific performance on the burdened property alone."). But see, FWT, Inc., 301 S.W.3d at 801-03.

In FWT, Inc. v. Haskin Wallace Mason Property Management, L.L.P., Haskin Wallace purchased certain real property (the Property) from FWT for the construction of a galvanizing facility. Id. at 789. The deed gave FWT a first-refusal right on the Property, if Haskin Wallace sold it. Id. at 789-90. Haskin Wallace created U.S. Galvanizing, L.P., to operate the galvanizing facility, and the facility was built on the Property. Id. at 790.

Haskin Wallace eventually entered into a contract selling the assets of U.S. Galvanizing and another galvanizing business to Valmont for $16,500,000, leasing the Property to Valmont for $25,000 per month for five years with two additional five-year options, and giving Valmont an option to purchase the Property for $2,500,000, subject to FWT's first-refusal right. Id. Pursuant to the right, Haskin Wallace sent FWT a letter notifying it of the agreement and advising it that Valmont's "purchase of one 'bundle of assets is contingent upon the purchase of another."' Id. FWT purported to exercise the right, but only as to the Property. Id. at 790-91. Haskin Wallace then sued for a declaratory judgment that FWT waived its right by failing to exercise it with respect to both the Property and the galvanizing companies' assets. Id. at 791.

On appeal, the Second Court of Appeals rejected FWT's argument that a grantor cannot condition the holder's ability to exercise a first-refusal right on the purchase of assets in addition to the burdened property. Id. at 793. In doing so, it distinguished or found inapposite five Texas cases standing for the proposition that a holder cannot be compelled to purchase, or require the grantor to sell, any property other than the burdened property: Navasota, McMillan, Comeaux, Riley, and Hinds. Id. at 794-99. Rather, citing West Texas Transmission L.P. v. Enron Corp., 907 F.2d 1554 (5th Cir. 1990), and its Texas progeny, Shell v. Austin Rehearsal Complex, Inc., No. 03-97-00411-CV, 1998 WL 476728 (Tex. App.--Austin Aug. 13, 1998, no pet.) (not designated for publication), and Texas State Optical, Inc. v. Wiggins, 882 S.W.2d 8 (Tex. App.--Houston [1st Dist.] 1994, no writ), the court held that, because Valmont's offer on the property was conditioned on the purchase of the galvanizing companies' assets, FWT had to comply with that condition unless it was commercially unreasonable or imposed in bad faith to defeat FWT's first-refusal right:

The language in the Deed also supports our decision to follow the West Texas Transmission line of cases. The Deed gives FWT a preferential right to purchase the Property at the same price and "under the same terms and conditions offered by the prospective purchaser," Valmont. Valmont conditioned its purchase or lease of the Property on its acquisition of the assets of the galvanizing businesses. FWT accepted the risk that it is now confronted with in this case because it agreed to language in the Deed allowing a third party to dictate the terms and conditions under which it would purchase or lease the Property. Applying Hinds, McMillan, and Navasota would effectively circumvent the parties' intent as expressed in the Deed.

FWT's argument that the parties could simply bundle burdened property with other assets to evade a preferential right is untenable in light of the three inquiries identified in West Texas Transmission. The West Texas Transmission line of cases affords a factfinder opportunity to make certain inquiries regarding the terms and conditions of a contract offered by a bona fide purchase (i.e., commercial reasonableness, bad faith, designed to defeat preferential right) when the preferential rightholder's decision to exercise its right is not unequivocal. These inquiries can protect the interests of both parties, as demonstrated in West Texas Transmission (the rightholder had to accept the challenged condition) and [Texas State Optical] (the rightholder did not have to accept the challenged conditions). This flexibility is particularly important in this case. When Haskin Wallace purchased the Property, it was undeveloped. Thereafter a multi-million dollar galvanizing business was constructed directly on the Property ....The commercial reasonableness and good faith regarding the challenged terms and conditions of Valmont's offer to Haskin Wallace are relevant considerations in light of the extensive improvements made to the Property. This is so because, absent an agreement to the contrary between U.S. Galvanizing and Haskin Wallace, U.S. Galvanizing's structures on the Property are likely fixtures. And FWT's claimed option to purchase the Property for $2.5 million does not include the value of the structures affixed to the Property. Thus, theoretically, applying the Hinds line of cases--which would allow FWT to purchase the Property for $2.5 million without also purchasing the assets of U.S. Galvanizing--could give FWT an ownership claim to the structures on the Property even though it did not pay for them. Applying Hinds, McMillan, and Navasota would not permit an inquiry into the considerations outlined in West Texas Transmission.

FWT, Inc. v. Haskin Wallace Prop. Mgmt., L.L.P., No. 2-08-321-CV, 2009 Tex. App. LEXIS 6953, at *37-40 (Tex. App.--Fort Worth Aug. 27, 2009) (citations omitted), withdrawn, 301 S.W.3d 787 (Tex. App.--Fort Worth 2009, pet. filed). Because no evidence existed that the condition to purchase the galvanizing businesses' assets was commercially unreasonable or imposed in bad faith to defeat FWT's first-refusal right, the court concluded that FWT waived its preferential right by not offering to purchase the galvanizing businesses' assets. Id. at *40.

The reasoning in FWT is questionable for a number of reasons. At the outset, it is contrary to the overwhelming majority of cases from both Texas and other jurisdictions that hold that a holder can neither be required to purchase nor require the grantor to sell any property besides the burdened property when it is sold as part of a package of other properties or a larger property. In fact, other cases involving comparable situations have concluded that the first-refusal right does not apply to personal property sold with the burdened property. E.g., Pantry Pride Enters., 806 F.2d at 1229 (holding that lessor's first-refusal right extended only to leasehold and not to the lessee's equipment); see Navasota Res., 249 S.W.3d at 537 (holding that the holder of a first-refusal right on an oil and gas interest was not required to purchase the interest and stock in the grantor's parent and to enter into a thirteen county area of mutual interest agreement); see also Holston Invests., Inc. B.V.I. v. Lanlogistics, Corp., No. 08-21569-CIV-MORENO, 2009 U.S. Dist. LEXIS 85419, at *10-11 (S.D. Fla. Sept. 18, 2009) (applying Florida law) (holding that sale of two other companies with the burdened company triggered first-refusal right only as to the burdened company); Radio Webs, Inc. v. Tele-Media Corp., 292 S.E.2d 712, 715 (Ga. 1982) (rejecting grantor's argument that holder should be required to purchase a second cable television station and other assets packaged with the cable television station burdened by the first-refusal right because it was economically infeasible to sell the two stations separately); Ollie v. Rainbolt, 669 P.2d 275, 281 (Okla. 1983) (rejecting grantor's argument that holder should be required to purchase both corporate stock burdened by first-refusal right and other stock).

Moreover, FWT's reliance on West Texas Transmission and its progeny is misplaced for two reasons. First, West Texas Transmission involved the sale of a single asset, a pipeline, rather than the sale of a package of assets. See W. Tex. Transmission, 907 F.2d at 1556-59. Second, as discussed in detail below, it is questionable whether West Texas Transmission's bad-faith requirement is consistent with Texas law. See infra Part V.B.

Finally, the decision appears to be one of a "hard case making bad law" because it clearly reflects the Second Court of Appeals' concern that FWT would receive a windfall if it were allowed to purchase only the Property. FWT, Inc., 2009 Tex. App. LEXIS 6953, at *40. This concern, however, was wholly unwarranted because it is tantamount to a rewriting of the first-refusal right. When it purchased the Property, Haskin Wallace planned to construct a galvanizing facility on it. Id. at *3. Thus, it could have insisted that the first-refusal right require FWT to purchase both the Property and the galvanizing business' assets, if they were sold together. The court's reasoning also ignores the fact that, in selling the galvanizing businesses, FWT could have structured the transaction to prevent an inequitable result by, for example, allocating a fair value to the Property and conditioning its sale on a long term or perpetual lease to Valmont.

113 E.g., Bill Signs Trucking, L.L.C. v. Signs Family Ltd. P'ship, 69 Cal. Rptr. 3d 589, 598-99 (Ct. App. 2007) (holding that tenant's first-refusal right under a commercial lease was not triggered by the conveyance of an interest in the property between the co-partners in a family limited partnership that owned the property and that was the landlord); Pellandini v. Valadao, 7 Cal Rptr. 3d 413, 417-18 (Ct. App. 2003) (concluding that the burdened property's sale between co-owners did not trigger first-refusal right); Byron Material, Inc. v. Ashelford, 339 N.E.2d 26, 29 (Ill. App. Ct. 1975) (holding that sale of an interest in leased property from one co-tenant to another did not trigger first-refusal right); Rucker Props., L.L.C. v. Friday, 204 P.3d 671, 676 (Kan. Ct. App. 2009) ("[B]ecause the conveyance ... was an intra-family gift and not a sale and no ownership was transferred to anyone outside of the lease agreement, the right of first refusal was not triggered."); Wilson v. Grey, 560 S.W.2d 561, 562 (Ky. 1978) (concluding that sale from one lessor to another did not trigger the lease's first-refusal right); Rogers v. Neiman, 193 N.W.2d 266, 267 (Neb. 1971) ("We think the proper construction of the lease was that an option existed only if the entire property was offered for sale by all of the lessors."); Baker v. McCarthy, 443 A.2d 138, 141 (N.H. 1982) ("The reference to the grantors in the plural, in our opinion, clearly contemplates that an offer to purchase would be made by a third party to the grantors as a whole group." (emphasis omitted)); Koella v. McHargue, 976 S.W.2d 658, 660 (Tenn. Ct. App. 1998) ("Our conclusion that the transfer between co-tenants did not trigger a right of first refusal protects defendants' rights against third-party purchases."); Tex. Co. v. Graf, 221 S.W.2d 865, 866 (Tex. Civ. App.--Fort Worth 1949, writ ref'd n.r.e.) (holding that a tenant in common's transfer of his interest in the burdened property to another tenant in common did not trigger the plaintiff tenant in common's first-refusal right).

114 A question exists regarding whether the typical first-refusal right, which is triggered by the receipt of an acceptable bona fide offer, is breached if the grantor enters into a contract with a third party conditioned on the holder's waiver of the right. Although one leading commentator on contract law maintains that a breach occurs, no reason exists why such a conditional contract should violate the first-refusal right. Compare Corbin, supra note 1, §11.3, at 480, with Cipriano v. Glen Cove Lodge No. 1458, B.P.O.E., 801 N.E.2d 388, 393 n.3 (N.Y. 2003).

115 E.g., Koch Indus., Inc. v. Sun Co., 918 F.2d 1203, 1212 (5th Cir. 1990) (applying Texas law); accord Roeland v. Trucano, 214 P.3d 343, 348 (Alaska 2009); Dyrdal v. Golden Nuggets, Inc., 672 N.W.2d 578, 584-85 (Minn. Ct. App. 2003); McMillan v. Dooley, 144 S.W.3d 159, 174, 177-78 (Tex. App.--Eastland 2004, pet. denied); John D. Stump & Assocs., Inc. v. Cunningham Mem'l Park, Inc., 419 S.E.2d 699, 706 (W. Va. 1992).

116 See Koch Indus., 918 F.2d at 1212; Roeland, 214 P.3d at 348; Union Oil Co. of Cal. v. Mobil Pipeline Co., No. Civ.A.19395-N, 2006 WL 3770834, at *15 (Del. Ch. Dec. 15, 2006); Drydal, 672 N.W.2d at 585; John D. Stump & Assocs., 419 S.E.2d at 706. But see Gyurkey v. Babler, 651 P.2d 928, 931 (Idaho 1982) (holding that the holder cannot be called upon to exercise or lose first-refusal right "unless the entire offer is communicated to him in such a form as to enable him to evaluate it and make a decision" (emphasis omitted)); Hancock v. Dusenberry, 715 P.2d 360, 364-65 (Idaho Ct. App. 1986) (applying Gyurkey).

117 Roeland, 214 P.3d at 348 n.11 ("[A]ll terms and entire offer must be communicated but copy of offer ordinarily sufficient so long as it contains full agreement between seller and third party."); Jordahl v. Concordia Coll., No. C1-97-825, 1998 WL 2411, at *3 (Minn. Ct. App. Jan. 6, 1998) (rejecting holder's complaint that there was improper notice because the notice only provided the third-party offer's essential terms); see Briggs v. Sylvestri, 714 A.2d 56, 59-60 (Conn. App. Ct. 1998) ("A letter of notice to the holder, which sets out the terms of the proposed transaction, is all that is required."); Union Oil Co., 2006 WL 3770834, at *14-15 (holding that holder need not match undisclosed price terms).

118 Koch Indus., 918 F.2d at 1212-13; McMillan, 144 S.W.3d at 177-78; Roeland, 214 P.3d at 348 & n.11; Dyrdal, 672 N.W.2d at 584; Matson v. Emory, 676 P.2d 1029, 1033 (Wash. Ct. App. 1984); see Eliminator, Inc. v. 4700 Holly Corp., 681 P.2d 536, 539 (Colo. Ct. App. 1984); Smith v. Hervo Realty Corp., 507 A.2d 980, 985-86 (Conn. 1986).

119 Koch Indus., 918 F.2d at 1212; accord Roeland, 214 P.3d at 349; McMillan, 144 S.W.3d at 177-82; Drydal, 672 N.W.2d at 585; John D. Stump & Assocs., 419 S.E.2d at 706; see Jordahl, 1998 WL 2411, at *3 (rejecting holder's complaint that there was improper notice because the notice provided the third party offer's essential terms).

120 See Jordahl, 1998 WL 2411, at *3.

121 E.g., Koch Indus., 918 F.2d at 1212-14 (holding that the holder must actually and formally seek clarification of any ambiguous terms in the third-party offer, and not merely object to the notice); Comeaux v. Suderman, 93 S.W.3d 215, 222-23 (Tex. App.--Houston

[14th Dist.] 2002, no pet.) (same); see Eliminator, 681 P.2d at 539 (holding that the holder's failure to inquire further about the third-party offer, not defective notice, was the cause of the holder's inability to exercise its first-refusal right). But see Roeland, 214 P.3d at 349 ("A right holder may fulfill this duty to investigate by asking about the specific unclear issues, seeking additional information, or advising the seller that the right holder considers the notice insufficient, vague, or ambiguous.").

122 John D. Stump & Assocs., 419 S.E.2d at 706; accord Koch Indus., 918 F.2d at 1212.

123 See Koch Indus., 918 F.2d at 1212; Drydal, 672 N.W.2d at 585-86; McMillan, 144 S.W.3d at 177-82; Comeaux, 93 S.W.3d at 222-23; John D. Stump & Assocs., 419 S.E.3d at 706.

124 E.g., Comeaux, 93 S.W.3d at 221.

125 E.g., Jordahl, 1998 WL 2411, at *3 (rejecting holder's complaint that improper notice existed due to an ambiguity in the purchase agreement's price terms because the holder received the essential terms and that was sufficient); Ellis v. Waldrop, 656 S.W.2d 902, 904 (Tex. 1983) (affirming a jury finding that the grantor substantially performed a first-refusal right's notice requirements and that the holder had waived its preferential right by failing to exercise it within the stated period); Durrett Dev., Inc. v. Gulf Coast Concrete, LLC, No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at *14 n.2 (Tex. App.--Houston [14th Dist.] Aug. 27, 2009, no. pet. h.) ("In the notice, the [grantor] made a reasonable disclosure of the terms of the proposed sale to [the third party] and of [the grantor's] willingness to accept the terms."); Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd., 225 S.W.3d 577, 591 (Tex. App.--El Paso 2005, pet. denied) ("The notice given was sufficient to reasonably disclose the proposed transaction and to provide Fasken entities an opportunity to exercise its preferential right ...even if there were technical deficiencies that rendered that notice less than perfect."); Comeaux, 93 S.W.3d at 221 ("We find that Suderman's notice to Comeaux, while not a model of clarity, reasonably disclosed Suderman's intention to sell the leased premises and additional property to a third party for a total price of $350,000."); Mecom v. Gallagher, 213 S.W.2d 304, 310-11 (Tex. Civ. App.--El Paso 1947, no writ) (opinion on rehearing) (holding that the notice's failure to comply with the first-refusal right's requirements was not a breach of the right because the holder discussed the third party's offer for the burdened property with both the grantors and their real-estate broker).

126 93 S.W.3d 215 (Tex. App.--Houston [14th Dist.] 2002, no pet.).

127 Id. at 217.

128 Id.

129 Id.

130 Id.

131 Id. at 218.

132 Id. at 221.

133 Id. at 222.

134 Id. at 221; accord Koch Indus., Inc. v. Sun Co., 918 F.2d 1203, 1212 (5th Cir. 1990); Drydal v. Golden Nuggets, Inc., 672 N.W.2d 578, 585-86 (Minn. Ct. App. 2003); Durrett Dev., Inc. v. Gulf Coast Concrete, LLC, No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at *13 n.2 (Tex. App.-- Houston [14th Dist.] Aug. 27, 2009, no. pet. h.); McMillan v. Dooley, 144 S.W.3d 159, 177-82 (Tex. App.--Eastland 2004, pet. denied); John D. Stump & Assocs., Inc. v. Cunningham Mem'l Park, Inc., 419 S.E.2d 699, 706 (W. Va. 1992). Significantly, in Comeaux, the burdened property was sold as part of a larger property and the holder was offered the opportunity to purchase only the larger property, and not just the burdened property. Despite this fact, the court placed the burden on the holder to insist on his right to purchase only the burdened property. Comeaux, 93 S.W.3d at 222-23; accord McMillan, 144 S.W.3d at 177-82.

135 Id. at 577.

136 Id. at 589-90.

137 Id. at 582.

138 Id. at 583-84.

139 Id. at 585.

140 Id. at 586, 589-90.

141 Id. at 590.

142 McMillan v. Dooley, 144 S.W.3d 159, 174 (Tex. App.--Eastland 2004, pet. denied).

143 Id.; accord Koch Indus., Inc. v. Sun Co., 918 F.2d 1203, 1212 (5th Cir. 1990). Atchison v. City of Englewood, 568 P.2d 13, 20 (Colo. 1977); Foster v. Bullard, 496 S.W.2d 724, 736-37 (Tex. Civ. App.--Amarillo 1973, writ ref'd n.r.e.).

144 Mandell v. Mandell, 214 S.W.3d 682, 688 (Tex. App.--Houston [14th Dist.] 2007, no pet.) (rejecting grantor's argument that the holder's knowledge about a contingent-fee contract giving the grantor's attorney a percentage of any recovery in a lawsuit against the holder was notice that the burdened property would be transferred to the attorney in satisfaction of the contingent-fee contract); Atchison, 568 P.2d at 20 (rejecting argument that the holder's claim was barred because he should have read newspaper accounts about the burdened property's sale).

145 See Koch Indus., 918 F.2d at 1212; Mandell, 214 S.W.2d at 688; McMillan, 144 S.W.3d at 174; A.G.E., Inc. v. Buford, 105 S.W.3d 667, 673 (Tex. App.--Austin 2003, pet. denied); Sanchez v. Dickinson, 551 S.W.2d 481, 485 (Tex. Civ. App.--San Antonio 1977, no writ); Martin v. Lott, 482 S.W.2d 917, 922-23 (Tex. Civ. App.--Dallas 1972, no writ).

146 McMillan, 144 S.W.3d at 173; A.G.E., Inc., 105 S.W.3d at 673.

147 Koch Indus., 918 F.2d at 1212; Martin, 482 S.W.2d at 921.

148 See infra note 337.

149 See supra note 55. On occasion, a first-refusal right will only require the holder to match the price offered by the third party. E.g., Kroehnke v. Zimmerman, 467 P.2d 265, 266 (Colo. 1970); Union Oil Co. of Cal. v. Mobil Pipeline Co., No. Civ.A.19395-N, 2006 WL 3770834, at *3 (Del. Ch. Dec. 15, 2006); Estate of Lien v. Pete Lien & Sons, Inc., 740 N.W.2d 115, 120 (S.D. 2007). In such cases, an obvious question arises regarding what constitutes the price, if the transaction is not an all cash one. Courts have considered this question:

While "price" obviously includes an amount of money, the common and ordinary meaning of "price" does not exclude non-monetary forms of consideration. "Price" is defined in Black's Law Dictionary 1207 (7th ed. 1999) as "[t]he amount of money or other consideration asked for or given in an exchange for something else; the cost at which something is bought or sold."

McMillan v. Dooley, 144 S.W.3d 159, 176 (Tex. App.--Eastland 2004, pet. denied) (emphasis in original); accord Union Oil Co. of Cal., 2006 WL 3770834, at *13 ("[T]he word 'price' does not simply mean 'cash.' 'Price' is essentially equivalent to 'consideration' and in the context of the [first-refusal right], it simply refers to all the material things that the seller will get in the deal--i.e., all of the consideration-related terms."); Estate of Lien, 740 N.W.2d at 120-21 (holding that the term "price" in a first-refusal right includes the cash paid and all non-monetary consideration).

150 E.g., Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 525-27 (Tex. App.--Amarillo 1998, pet. denied); Matson v. Emory, 676 P.2d 1029, 1033 (Wash. Ct. App. 1984).

151 E.g., Steinberg v. Sachs, 837 So. 2d 503, 505-06 (Fla. Dist. Ct. App. 2003); IH Riverdale, L.L.C. v. McChesney Capital Partners, L.L.C., 633 S.E.2d 382, 386-87 (Ga. Ct. App. 2006); but cf. KMI Cont'l Offshore Prod. Co. v. ACF Petroleum Co., 746 S.W.2d 238, 244 (Tex. App.--Houston [1st Dist.] 1987, writ denied) (holding that when an option fails to impose a time limit on its exercise, it must be exercised within a reasonable time); Maupin v. Dunn, 678 S.W.2d 180, 183 (Tex. App.--Waco 1984, no writ) (same).

152 Maloney v. Atlantique Condo. Complex Ass'n, 399 So. 2d 1111, 1114 (Fla. Dist. Ct. App. 1981).

153 E.g., Smith v. Hevro Realty Corp., 507 A.2d 980, 985 (Conn. 1986); Maloney, 399 So. 2d at 1113; Romain v. A. Howard Wholesale Co., 506 N.E.2d 1124, 1128 (Ind. Ct. App. 1987); Santos v. Dean, 982 P.2d 632, 635-36 (Wash. Ct. App. 1999); see Corbin, supra note 1, §11.8, at 527.

154 Restatement (Second) of Contracts §63(b) (1981); accord Maloney, 399 So. 2d at 1113; Santos, 982 P.2d at 635; see Corbin, supra note 1, §11.8, at 527.

155 E.g., Abraham Inv., 968 S.W.2d at 525 (holding that where the notice required the holder to exercise its right by signing and returning the notice letter, an oral acceptance was insufficient); see Corbin, supra note 1, §11.8, at 518, 529 (noting that if an option contract requires a particular mode of acceptance, the optionee must give notice of the option's exercise in that mode); 2 Samuel Williston, A Treatise on the Law of Contracts §6.12, at 125-26 (2007) ("[T]he manner of acceptance may be specified in the offer, as a condition to acceptance, in which case it must be complied with in order for a contract to be formed.").

156 See supra note 7.

157 E.g., Durrett Dev., Inc. v. Gulf Coast Concrete, LLC, No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at *12 (Tex. App.--Houston [14th Dist.] Aug. 27, 2009, no. pet. h.); FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P., No. 2-08-321-CV, 2009 Tex. App. LEXIS 6953, at *14 (Tex. App.--Fort Worth 2009, pet. denied), withdrawn, 301 S.W.3d 787 (Tex. App.--Fort Worth 2009, pet. filed); Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 533 (Tex. App.--Waco 2008, pet. denied); City of Brownsville v. Golden Spread Elec. Coop., Inc., 192 S.W.3d 876, 880 (Tex. App.--Dallas 2006, pet. denied).

158 W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1565 (5th Cir. 1990) (quoting Scott v. Vandor, 671 S.W.2d 79, 84 (Tex. App.-- Houston [1st Dist.] 1984, writ ref'd n.r.e.)); accord City of Brownsville, 192 S.W.3d at 880 ("The rightholder's exercise of the option must be positive, unconditional, and unequivocal. The rightholder must accept all the terms of the offer or the offer will be considered rejected. In the absence of an agreement otherwise, unequivocal acceptance of the terms of the offer is considered an exercise of the right to purchase." (citations omitted)); Navasota Res., 249 S.W.3d at 533 (same); Tex. State Optical, Inc. v. Wiggins, 882 S.W.2d 8, 10-11 (Tex. App.--Houston [1st Dist.] 1994, no writ) ("The exercise of an option, like the acceptance of any other offer, must be positive and unequivocal. As a general rule, an acceptance of an offer must not change or qualify the terms of an offer, and if it does, the offer is rejected. With regard to an option, generally a purported acceptance containing a new demand, proposal, condition, or modification of the terms of the offer is not an acceptance, but a rejection." (citations omitted)).

159 W. Tex. Transmission, 907 F.2d at 1564 (rejecting the holder's argument that the phrase "terms and conditions" only required it to match the price terms); accord Weisser v. Wal-Mart Real Estate Bus. Trust, No. 04-15, 2005 U.S. Dist. LEXIS 11185, at *18-24 (E.D. Ky. June 8, 2005) (holding that the holder's modification of the third-party offer's default provision and addition of environmental provision was not a proper exercise of first-refusal right); Smith v. Hevro Realty Corp., 507 A.2d 980, 985 (Conn. 1986) (holding that the holder's failure to pay earnest money when it purported to exercise the first-refusal right as required by the triggering offer was not a proper acceptance); USA Cable v. World Wrestling Fed'n. Entm't, Inc., 766 A.2d 462, 471, 474 (Del. 2000) (holding that the holder's failure to match forum-selection and cross-promotion provisions of the third party's offer was not a proper acceptance); Christian v. Edelin, 843 N.E.2d 1112, 1115 (Mass. App. Ct. 2006) (holding that the holder's acceptance, which was subject to a mortgage contingency, did not match the third party's all cash offer); Weber Meadow-View Corp. v. Wilde, 575 P.2d 1053, 1055 (Utah 1978) (holding that the holder's offer to pay $200,000 in cash plus any house of grantor's choosing worth $50,000 for burdened property or less did not match the third party's offer of $200,000 in cash plus a specific house); John D. Stump & Assocs., Inc. v. Cunningham Mem'l Park, Inc., 419 S.E.2d 699, 705 (W. Va. 1992) (concluding that the holder's purported acceptance that rejected a provision in the triggering offer providing for cash consideration for the grantor's covenant not to compete and that conditioned holder's acceptance on his ability to obtain financing was "not a clear and unequivocal acceptance of the [grantor's] offer to sell, and, therefore, as a matter of law, the [grantor] could reject his response").

160 E.g., 1 Arthur Litton Corbin, Corbin on Contracts §3.29, at 464 (Joseph M. Perillo ed., rev. ed. 1993) ("If the offeree changes any term [of the offer], the offeree is not accepting the offer. The offeror and the offeree, alike, must express agreement as to every term of the contract. The offeror does this in the offer. The offeree must do it in the acceptance."); Joseph M. Perillo, Calamari & Perillo on Contracts §2.21(a), at 85 (6th ed. 2009) ("The common law rule is that a purported acceptance that adds qualifications or conditions operates as a counter offer and thereby a rejection of the offer....Courts have enforced this rule, sometimes called the 'ribbon matching' or 'mirror image' rule, with a rigor worthy of a better cause." (footnotes omitted)); see Williston, supra note 155, §6.11, at 107 ("[I]t is generally required in order to form a contract that the offeree pays, in return for the offeror's promise, exactly the consideration that the offeror has sought as the price for the promise.").

Many jurisdictions do not require the holder to match "immaterial" terms or conditions in the triggering offer. E.g., Miller v. LeSea Broad., Inc., 87 F.3d 224, 226-28 (7th Cir. 1996) (applying Wisconsin law) (noting that a majority of cases do not require matching of immaterial terms, and those cases do not "let insubstantial variations between the third party's offer and the right holder's offer defeat the right"); Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854, 858 (Fla. Dist. Ct. App. 1970) ("One offer to purchase matches another only if the essential terms of the offers are identical."); Davis v. Iofredo, 713 N.E.2d 26, 28 (Ohio Ct. App. 1998) ("[I]t has long been recognized that a provision contained in a grant of a right of first refusal that states that the right must be exercised upon the same terms and conditions as are contained in a third party's offer, requires only that the right be exercised upon the same material or essential terms as are contained in such an offer."); Prince v. Elm Inv. Co., 649 P.2d 820, 825 (Utah 1982) ("If the holder of the right of first refusal cannot meet exactly the terms and conditions of the third person's offer, minor variations which obviously constitute no substantial departure should be allowed." (quoting Brownies Creek Collieries, Inc. v. Asher Coal Mining Co., 417 S.W.2d 249, 252 (Ky. 1967))); Matson v. Emory, 676 P.2d 1029, 1033 (Wash. Ct. App. 1981) (holding that the exercise of a first-refusal right constitutes a counteroffer, not an acceptance, when the acceptance differs materially from the triggering offer); John D. Stump & Assocs., 419 S.E.2d at 705 ("[W]here the acceptance of a pre-emptive rightholder varies materially from the terms of the third party's offer, it is viewed as a rejection of the seller's offer and terminates the option right.").

161 907 F.2d 1554 (5th Cir. 1990).

162 Id. at 1556.

163 Id.

164 Id. at 1157-58. To obtain approval of the merger transaction in which Enron acquired its interest in the pipeline, Enron entered into a consent decree with the FTC providing that it could divest the pipeline and certain other assets "only in a manner that receives the prior approval of the [FTC]." Id. at 1557.

165 Id. at 1558-59.

166 Id. at 1559-60.

167 Id. at 1561.

168 Id. at 1563-64.

169 Id. at 1563. The Fifth Circuit ultimately held that the FTC approval condition was "commercially reasonable, imposed in good faith, and not specifically designed to defeat [Valero's] preemptive rights:"

(1)" Enron and TECO agreed to include the approval term only after extensive arms length negotiations which resulted in a comprehensive pipeline purchase agreement [and] Enron did not dictate the approval term to TECO, or coerce TECO into accepting that term[;]" and (2)" business venturers routinely subject their contracts to outside approval for financing or creditworthiness in order to guarantee the financial success of the venture [and, f]or Enron, the FTC approval requirement serves a similar function [because] without that term, Enron risked a fine of $10,000 dollars per day under the consent decree if the FTC disapproved of the pipeline acquirer."

Id. at 1563-64.

170 Other jurisdictions impose a "good-faith" requirement on the grantor. E.g., Miller, 87 F.3d at 228 ("[T]he grantor ...may not act in bad faith, which in this context means may not, for the purposes of discouraging the exercise of the right, procure from the third-party terms that the grantor knows are unacceptable to the holder of the right of first refusal." (citing, among other cases, West Texas Transmission)); Or. RSA No. 6, Inc. v. Castle Rock Cellular of Or. Ltd. P'ship., 76 F.3d 1003, 1007 (9th Cir. 1996) (applying Oregon law) (holding that grantor's actions violated the implied covenant of good faith and fair dealing implied in every contract formed under Oregon law, including first-refusal rights); Seessel Holdings, Inc. v. Fleming Cos., 949 F. Supp. 572, 576-77 (W.D. Tenn. 1996) (applying Tennessee law) (following West Texas Transmission); In re New Era Resorts, LLC, 238 B.R. 381, 386-87 (Bankr. E.D. Tenn. 1999) (applying Tennessee law) (following West Texas Transmission); Roeland v. Trucano, 214 P.3d 343, 349 (Alaska 2009) (following West Texas Transmission); Brownies Creek Collieries, Inc. v. Asher Coal Mining Co., 417 S.W.2d 249, 252 (Ky. Ct. App. 1967) ("[D]efeat of the right of refusal should not be allowed by use of special, peculiar terms or conditions not made in good faith."); Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 963-64 (Mass. 2004) (implying covenant of good faith and fair dealing in a first-refusal right, but holding that the covenant was not breached); David A. Bramble, Inc. v. Thomas, 914 A.2d 136, 148-49 (Md. 2007) ("We believe that imposing upon the [grantor] and third-party purchaser an implied duty of good faith and fair dealing strikes the proper balance. A good-faith requirement preserves a property owner's right to dispose of property as he, she, or it deems appropriate, thus maintaining marketability of the property. This approach protects, at the same time, the equitable property interest that the preemptioner holds in the encumbered property....We conclude, therefore, that the 'terms upon which the [grantor] would sell her property remains her prerogative so long as she acts in good faith.'" (quoting Matson v. Emory, 676 P.2d 1029, 1032 (Wash. Ct. App. 1984))); St. George's Dragons, L.P. v. Newport Real Estate Group, L.L.C., 971 A.2d 1087, 1100 (N.J. Super. Ct. App. Div. 2009) (quoting Seessel, 949 F. Supp. at 576-77); Davis v. Iofredo, 713 N.E.2d 26, 28 (Ohio Ct. App. 1998)

(quoting Brownies Creek, 417 S.W.2d at 252); Prince v. Elm Inv. Co., 649 P.2d 820, 825 (Utah 1982) ("And defeat of the right of refusal should not be allowed by use of special, peculiar terms or conditions not made in good faith."); Weber Meadow-View Corp. v. Wilde, 575 P.2d 1053, 1055 (Utah 1978) (holding that the grantor's "decision as to ...terms upon which the [grantor] would sell her property remains her prerogative so long as she acts in good faith and without any ulterior purpose to defeat the right of the [holder]"); see Matson, 676 P.2d at 1031 ("The [first-refusal] right is a valuable contract right which should not be rendered illusory by imposing requirement that are impossible to meet.").

171 882 S.W.2d 8 (Tex. App.--Houston [1st Dist.] 1994, no writ).

172 Id. at 11 (citation omitted).

173 See generally No. 03-97-00411-CV, 1998 WL 476728 (Tex. App.-- Austin Aug. 13, 1998, no pet.) (not designated for publication).

174 No. 2-08-321-CV, 2009 Tex. App. LEXIS 6953, at *36-37 (Tex. App.--Fort Worth Aug. 27, 2009, pet. denied), withdrawn, 301 SW3d 787 (Tex. App.--Fort Worth 2009, pet. filed).

175 Shell, 1998 WL 476728, at *9 (citations omitted). See supra note 112 for a detailed discussion of FWT.

176 Tex. State Optical, 882 S.W.2d at 12 (Cohen, J. dissenting).

177 968 S.W.2d 518 (Tex. App.--Amarillo 1998, pet. denied).

178 Id. at 526-27. The court, however, did not leave holders without a remedy:

[W]e will directly follow Texas law. In [Jones v. Gibbs, 133 Tex. 627, 638-42, 130 S.W.2d 265, 271-73 (1939)], the court explicated the general rule regarding equitable relief in such cases. Equitable relief will be granted when the offeree failed to accept the offer within an option agreement if such failure resulted from fraud, surprise, accident, or mistake. Equally, estoppel principles may apply if the offeror's conduct prevented the offeree from properly making his acceptance.

Abraham Inv., 968 S.W.2d at 527.

179 144 S.W.3d 159 (Tex. App.--Eastland 2004, pet. denied).

180 Id. at 177.

181 See Miller v. LeSea Broad., Inc., 87 F.3d 224, 228 (7th Cir. 1996); David A. Bramble, Inc. v. Thomas, 914 A.2d 136, 149 (Md. 2007); Prince v. Elm Inv. Co., 649 P.2d 820, 825 (Utah 1982).

182 E.g., W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1563 (5th Cir. 1990).

183 Compare Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 963-64 (Mass. 2004) (holding that a third party's offer to purchase burdened property for a price exceeding its fair market value was bona fide because "the holder...runs the risk that the third party will agree to a price that is above market value or that is above what the holder is able to pay.") and Shepherd v. Davis, 574 S.E.2d 514, 521 (Va. 2003) (rejecting argument that a third party's offer was not bona fide because its terms "were designed to make it unreasonable for him to purchase the Property") with Raytheon Co. v. Rheem Mfg. Co., 322 F.2d 173, 178-80 (9th Cir. 1963) (applying California law) (holding that grantor's parent corporation's offer for equipment burdened by first-refusal right was not bona fide because its price was not based on market value, but rather on its value to the holder).

184 Compare, e.g., W. Tex. Transmission, 907 F.2d at 1563 ("Where two sophisticated businesses reach a hard fought agreement through lengthy negotiation, it is difficult to conclude that any negotiated term placed in their contract is commercially unreasonable."), Uno Rests., 805 N.E.2d at 965 (holding that term was not imposed in bad faith where "[t]here was no evidence that [the grantor] influenced or attempted to influence" the third party's offer), and Shepherd, 574 S.E.2d at 521 (rejecting argument that a third party's offer was not bona fide because its terms "were more burdensome for" the holder) with Shell v. Austin Rehearsal Complex, Inc., No. 03-97-0411-CV, 1998 WL 476728, at *10 (Tex. App.--Austin Aug. 13, 1998, no pet.) (not designated for publication) (affirming a jury finding of bad faith because there "was evidence that before [the lessee-holder] expressed its intent to expand, the [lessors-grantors] included a shorter list of restrictive terms in their notices of offer. After being notified of [the lessee-holder's] intent to expand, however, [the lessors-grantors] added restrictive terms to their list. Those actions raise an inference that [the lessors-grantors] consciously set out to defeat [the lessee-holder's] right of first refusal. There was also evidence that although [the lessor-grantor] took the list of terms from a standard commercial lease form, they altered some of the terms to make them more restrictive...."), Miller, 87 F.3d at 228 (holding

that a grantor may not "procure from the third-party terms that the grantor knows are unacceptable to the holder"), and Bramble, 914 A.2d at 150 (holding that "[t]he manner in which the provision was added, i.e., by a hand written addendum attached to the contract of sale, may support an inference that the 'no mining' clause was an after the fact method of frustrating [the holder's] preemptive right by including a term or condition which the parties knew [the holder] would not accept").

185 E.g., W. Tex. Transmission, 907 F.2d at 1563; Prince, 649 P.2d at 825.

186 See W. Tex. Transmission, 907 F.2d at 1563. In fact, the citations following West Texas Transmission's bad-faith exception include only one Texas case, Holland v. Fleming, 728 S.W.2d 820 (Tex. App.--Houston [1st Dist.] 1987, writ ref'd n.r.e.). Holland, however, does not support the exception. Rather, in Holland, the issue was whether a contract to sell the burdened property, which was canceled three days after its execution and before the grantor gave notice to the holder, triggered a first-refusal right. Id. at 823 ("We next consider the [grantor's] contention that the [holders'] right of first refusal never matured, because her earnest money contract with the third party was canceled before she gave or was required to give notice to [the holders] of her election to sell.").

187 Compare, e.g., Petro Franchise Sys., L.L.C. v. All Am. Props., Inc., 607 F. Supp. 2d 781, 793 (W.D. Tex. 2009) (applying Texas law) ("[A] duty of good faith and fair dealing does not exist in Texas unless intentionally created by express language in a contract or unless a special relation of trust and confidence exists between the parties...." (quoting Lovell v. W. Nat'l Life Ins. Co., 754 S.W.2d 298, 302 (Tex. App.--Amarillo 1988, writ denied))), and Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 595 n.5 (Tex. 1992) ("We, however, have specifically rejected the implication of a general duty of good faith and fair dealing in all contracts."), and UMLIC VP L.L.C. v. T & M Sales & Envtl. Sys., Inc. 176 S.W.3d 595, 612 (Tex. App.--Corpus Christi 2005, pet. denied) ("The Texas Supreme Court has declined to impose an implied duty of good faith and fair dealing in every contract, though it has recognized that such a duty may arise as a result of 'a special relationship between the parties governed or created by a contract.'" (quoting Arnold v. Nat'l County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987))), with Or. RSA No. 6, Inc. v. Castle Rock Cellular of Or. L.P., 76 F.3d 1003, 1007 (9th Cir. 1996) (applying implied covenant of good faith and fair dealing to first-refusal right), Uno Rests. 805 N.E.2d at 964 (same), and Bramble, 914 A.2d at 148-49 (same).

188 See W. Tex. Transmission, 907 F.2d at 1563. Because most first-refusal rights are triggered by a third party's bona fide offer and because a bona fide offer is one made in good faith, a holder may argue that an offer made to defeat its first-refusal right is not made in good faith. Any such argument seems incorrect because the third party has no obligation to the holder and because the good-faith requirement relates to the offer, and not to the first-refusal right. See discussion supra note 64.

189 See Bramble, 914 A.2d at 144 ("[W]ithout [an exact matching requirement], the right [of first refusal] is an impediment to the marketability of property, because it gives the holder of the right a practical power to impede a sale to a third party by refusing to match the third party's offer exactly and then arguing that the discrepancy was immaterial." (quoting Miller v. LeSea Broad., Inc., 87 F.3d 224, 226 (7th Cir. 1996))).

190 See W. Tex. Transmission, 907 F.2d at 1563 ("Whether a specific condition is reasonable must be determined by examining the circumstances of a particular case."); Miller, 87 F.3d at 230 (remanding case for determination of whether certain terms of the triggering offer were imposed in bad faith); Bramble, 914 A.2d at 149, 150 (holding that "good faith ordinarily is a question of fact for summary judgment purposes" and that "[w]hether a specific term or condition is commercially reasonable, i.e., inserted in good faith, is a case-by-case determination"); Beard v. Whitaker, No. 05-96-01188-CV, 1998 WL 423453, at *3 (Tex. App.--Dallas July 29, 1998, pet. denied) (not designated for publication) ("Normally, the issue of good faith involves a question of fact."); Bennett v. Computer Assocs. Int'l, Inc., 932 S.W.2d 197, 204 (Tex. App.--Amarillo 1996, writ denied) ("As to the matter of good faith, we must remember that it inherently involves a question of fact."); Prince, 649 P.2d at 826 (remanding case for determination of whether certain terms of the triggering offer were imposed in bad faith).

191 See Crivelli v. Gen. Motors Corp., 215 F.3d 386, 389 (3d Cir. 2000) ("A right of first refusal grants the holder...the option to purchase the grantor's...property on the terms and conditions of sale contained in a bona fide offer by a third party to purchase such property."); In re Bergt, 241 B.R. 17, 20 (Bankr. D. Alaska 1999) ("The holder of such a right has the option to purchase the grantor's real estate on the terms and conditions of sale contained in a bona fide offer by a third party to purchase such real estate....").

192 See Times Herald Printing v. A.H. Belo Corp., 820 S.W.2d 206, 215 (Tex. App.--Houston [14th Dist.] 1991, no writ) (holding that a competitor is free to cause the termination of a business relationship by offering better contract terms or a higher price); Kingsbery v. Phillips Petroleum Co., 315 S.W.2d 561, 576 (Tex. Civ. App.--Austin 1958, writ ref'd n.r.e.) (holding that an oil jobber's business

competitor was privileged to use lawful means to induce the jobber's supplier to cancel the jobber's contract and give jobbership to the competitor).

193 Of course, at the extreme, a grantor's negotiation of a sales price that is greater than the property's market value or greater than what the grantor knows or believes the holder is able or willing to pay should constitute a violation of West Texas Transmission's good-faith requirement. But no case has ever so held. E.g., Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 964 (Mass. 2004) (noting that "[n]othing precluded [the third party] from trying to outbid [the holder] by offering a price that [the holder] was unlikely to match."); Rappaport v. Banfield, 924 A.2d 72, 79 (Vt. 2007) ("A prospective buyer may inflate the price for a parcel, or be motivated by a desire to defeat a right of first refusal, and still make a bona fide offer."). It is difficult to understand why a grantor's negotiation of a sales price that it knows exceeds the market price or the price the holder is willing or able to pay does not violate the good-faith requirement, whereas the inclusion of non-cash economic terms or non-economic terms intended defeat the first-refusal right can do so.

194 See infra Part II.D. for discussion on intended protections of a first-refusal right.

195 E.g., Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640, 646 (Tex. 1996) (noting that a court should not rewrite a first-refusal right "to insert provisions parties could have included or to imply restraints for which they have not bargained").

196 No. 03-97-00411-CV, 1998 WL 476728, at *9-10 (Tex. App.--Austin Aug. 13, 1998, no pet.) (not designated for publication).

197 See infra Part X.A.

198 See also supra note 112 (discussing FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P., No. 2-08-321-CV, 2009 WL 4114140, at *5 (Tex. App.-- Fort Worth Aug. 27, 2009), withdrawn, 301 S.W.3d 787 (Tex. App.--Fort Worth 2009, pet. filed)).

199 914 A.2d 136 (Md. 2007).

200 Id. at 138.

201 See Comeaux v. Suderman, 93 S.W.3d 215, 220 (Tex. App.--Houston [14th Dist.] 2002, no pet.) ("A right of first refusal ripens into an option when the owner elects to sell.").

202 E.g., Jones v. Gibbs, 133 Tex. 627, 639-43, 130 S.W.2d 265, 271-73 (1939) (discussing an optionee's remedies); Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 527 (Tex. App.--Amarillo 1998, pet. denied).

203 See Prince v. Elm Inv. Co., 649 P.2d 820, 823-26 (Utah 1982) (involving the burdened property's exchange for a partnership interest); Weber Meadow-View Corp. v. Wilde, 575 P.2d 1053, 1055 (Utah 1978) (involving the burdened property's sale for $200,000 in cash and a house); Matson v. Emory, 676 P.2d 1029, 1031 (Wash. Ct. App. 1984) (involving the burdened property's exchange for another property).

204 See Kunelius v. Town of Stow, 588 F.3d 1, 12 (1st Cir. 2009) ("[T]he holder of [a right of first refusal] must meet all of the terms and conditions of the offer...."); In re New Era Resorts, L.L.C., 238 B.R. 381, 385 (Bankr. E.D. Tenn. 1999) ("[T]he party exercising the right of first refusal must strictly match the terms of the third party's offer....").

205 E.g., W. Tex. Transmission, L.P. v. Enron Corp., 907 F.2d 1554, 1564-65 (5th Cir. 1990) ("[M]ost courts have insisted that [holders] replicate a myriad of non-price conditions, including terms requiring adequate credit and special payment terms; the assumption of real-estate commissions; additional partnership and land development obligations; the exchange of land parcels rather than a cash transaction; and the purchase of a larger quantity of land.... [A] purported acceptance which leaves the [grantor] 'as well off' as a third-party offer, but which modifies, adds to or otherwise qualifies the terms of the offer, generally constitutes a rejection of the offer and a counter offer."); Weber Meadow-View, 575 P.2d at 1055 (holding that holder's offer to pay $200,000 in cash and any house of grantor's choosing worth $50,000 or less for burdened property did not match third party's offer of $200,000 in cash plus a specific house); Matson, 676 P.2d at 1032-33 ("Allowing [the holder's] all cash offer to meet the terms and conditions of a property exchange would force [the grantor] to dispose of the property in a manner unacceptable to him" and that "offers [that] arguably leave the property owner 'as well off' as does the third-party offer, but which vary materially from it render the purported acceptance a counter offer." (citations omitted)); Daskal, supra note 1, at 466 ("The [holder] bears the risk that the [grantor] may only be prepared to sell the burdened property for unique consideration or under unconventional conditions. For example, the [grantor] may be willing to accept a property exchange rather than a cash payment. Or she may be willing to sell only for an interest in a commercial partnership.").

206 See C. Robert Nattress & Assocs. v. CIDCO, 229 Cal. Rptr. 33, 43 (Dist. Ct. App. 1986) ("If the literal matching of terms were required, a [third party] could by offering some unique consideration such as existing trust deed notes, a bag of diamonds or a herd of Arabian horses, effectively defeat the [holder's] right of first refusal. How would the holder of the right of first refusal in such a case make an offer to exercise the right of first refusal on the same terms and conditions as in the triggering offer?"); see also Vincent v. Doebert, 539 N.E.2d 856, 861-62 (Ill. App. Ct. 1989) (stating the holder of right of first refusal was not required to match net worth of third-party offeror).

207 See, e.g., Prince, 649 P.2d at 825 ("[W]here the third party offer includes a house that the [grantor] intends to use as a personal residence, the [grantor's] personal preference for that house as a basis for rejecting the [holder's] offer might be eminently reasonable. On the other hand, if the seller intended to use the offered house as a rental property, an explanation in commercial terms is probably required to meet the reasonableness standard."); Nw. Television Club, Inc. v. Gross Seattle, Inc., 634 P.2d 837, 841-42 (Wash. 1981), modified on other grounds, 640 P.2d 710 (Wash. 1982) (holding that, where third party's offer was conditioned on sale of a residence, holder's offer, which was based on the sale of another residence, was an exact match because in both offers the sales were a means of raising the funds for the burdened property's purchase).

208 E.g., W. Tex. Transmission, 907 F.2d at 1563; Prince, 649 P.2d at 825; Matson, 676 P.2d at 1032; Daskal, supra note 1, at 466 ("So long as the [unique] conditions of the sale are commercially reasonable, imposed in good faith, and not specifically designed to defeat the right of first refusal, the right holder will be obligated to match the offer if she wishes to exercise her first-refusal privilege.").

209 Matson, 676 P.2d at 1032 (quoting Prince, 649 P.2d at 825).

210 Chevy Chase Servs., Inc. v. Marceron, 314 F.2d 275, 276 (D.C. Cir. 1963) (third-party offering a first trust on the remaining balance of the purchase price).

211 Miller v. LeSea Broad., Inc., 87 F.3d 224, 228-29 (7th Cir. 1996) (third party included guarantee by another entity for outstanding obligations, including purchase price).

212 Christian v. Edelin, 843 N.E.2d 1112, 1115 (Mass. App. Ct. 2006) (owner accepted an offer from a third party subject to a reasonable mortgage contingency date).

213 E.g., Foster v. Hanni, 841 P.2d 164, 170-71 (Alaska 1992); accord Chevy Chase Servs., 314 F.2d at 277 (holding that the grantor could refuse the holder's offer to give the grantor a junior lien on the burdened tract when the third party offered a senior lien); Smith v. Hevro Realty Corp., 507 A.2d 980, 986 (Conn. 1986) (holding that the holder could not ignore the third party's promise to render a deposit with acceptance); see Christian, 843 N.E.2d at 1115 (holding that the holder's acceptance, which was subject to a mortgage contingency, did not match the third party's all cash offer).

214 E.g., Miller, 87 F.3d at 228-29 (holding that if the owner requires a guarantor for the third party's obligation, the owner may reasonably require one from the holder); Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854, 858 (Fla. Dist. Ct. App. 1970) (holding that the holder's proposed payment schedule with a lower present discounted value than that in the triggering offer was not a match).

215 240 Cal. Rptr. 189, 190 (Dist. Ct. App. 1987).

216 Id. at 190-93.

217 Id. at 194.

218 See Matson v. Emory, 676 P.2d 1029, 1031 (Wash. Ct. App. 1984) (stating that the holder offered to pay an additional amount equal to the negative tax consequences).

219 See Shell Oil Co. v. Trailer & Truck Repair Co., 828 F.2d 205, 208 (3d Cir. 1987) (applying New Jersey law); Pantry Pride Enters., Inc. v. Stop & Shop Cos., 806 F.2d 1227, 1228 (4th Cir. 1986) (applying Virginia law).

220 Shell Oil Co., 828 F.2d at 210 (applying New Jersey law); Pantry Pride Enters., 806 F.2d at 1231-32 (applying Virginia law); Wilson v. Brown, 55 P.2d 485, 486 (Cal. 1936); Park Plaza, Ltd. v. Pietz, 239 Cal. Rptr. 51, 54 (Dist. Ct. App. 1987), overruled on other grounds by Moncharsh v. Heily & Blase, 832 P.2d 899, 906 (Cal. 1992); Brenner v. Duncan, 27 N.W.2d 320, 322 (Mich. 1947); Berry-Iverson Co. of N.D. v. Johnson, 242 N.W.2d 126, 132-33 (N.D. 1976); Wilber Lime Prods., Inc. v. Ahrndt, 673 N.W.2d 339, 342-43 (Wis. Ct. App. 2003).

221 See Foster v. Bullard, 554 S.W.2d 66, 67 (Tex. Civ. App.--Austin 1977, writ ref'd n.r.e.).

222 Id.

223 Id. at 67-68.

224 Id. at 71; accord Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 187 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd by agr.) (holding that when a package of condominiums, including one burdened with a first-refusal right, was sold for $76.20 per square foot, the lessee-holder could exercise his right at that per square foot price).

225 E.g., Gleason v. Norwest Mortgage, Inc., 243 F.3d 130, 142-43 (3d Cir. 2001) (applying Minnesota law); Shell Oil Co., 828 F.2d at 208-10; Pantry Pride Enters., 806 F.2d at 1231; In re Adelphia Commc'ns Corp., 368 B.R. 348, 352-53, 357-58 (Bankr. S.D.N.Y. 2007) (applying North Carolina law); Park Plaza, 239 Cal. Rptr. at 54-55; Uno Rests., Inc. v. Boston Kenmore Realty Corp., 805 N.E.2d 957, 963 (Mass. 2004); Unlimited Equip. Lines, Inc. v. Graphic Arts Ctr., Inc., 889 S.W.2d 926, 939 (Mo. Ct. App. 1994); Samson Res. Co. v. Amerada Hess Corp., 41 P.3d 1055, 1059 (Okla. Civ. App. 2001); Wilber Lime Prods., 673 N.W.2d at 342-43; Rappaport v. Banfield, 924 A.2d 72, 79-80 (Vt. 2007).

226 See Park Plaza, 239 Cal. Rptr. at 54-55; Uno Rests., 805 N.E.2d at 963; Unlimited Equip. Lines, 889 S.W.2d at 939; Samson Res., 41 P.3d at 1059; Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 542-43 (Tex. App.--Waco 2008, pet. denied); Rappaport, 924 A.2d at 79-80.
Other courts hold that the burdened property's price should be based on the proportion of the purchase price that its fair market value bears to the fair market value of the package or the entire parcel, as determined by the trier of fact. Shell Oil, 828 F.2d at 208-10; Pantry Pride Enters., Inc. v. Stop & Shop, Inc., 806 F.2d 1227, 1231 (4th Cir. 1986); Wilber Lime, 673 N.W.2d at 342-43.

227 See Rappaport, 924 A.2d at 79 ("A bona fide offer is one made 'honestly and with serious intent' where 'the offeror genuinely intends to bind itself to pay the offered price"' (quoting Uno Rests., 805 N.E.2d at 963)).

228 See supra note 59 and accompanying text.

229 E.g., Smith v. Bertram, 603 N.W.2d 568, 571 (Iowa 1999); M & M Oil Co. v. Finch, 640 P.2d 317, 318 (Kan. Ct. App. 1982); Shepherd v. Davis, 574 S.E.2d 514, 516 (Va. 2003); see Corbin, supra note 1, §11.5, at 495 (referring to "dual purchase provisions").

230 M & M Oil, 640 P.2d at 320 ("Cases dealing with dual options recognize that the terms of the particular clauses control."); Shepherd, 574 S.E.2d at 520 ("[C]ourts agree that the interpretation of dual option provisions turns upon the particular language used and that a decision construing a dual option in one agreement will not necessarily be persuasive or controlling in a case involving a different agreement.).

231 Shepherd, 574 S.E.2d at 520.

232 E.g., id. at 520-21 (discussing cases and holding that, under the lease's unambiguous language, once the optionee/holder received notice of the third party's offer, the fixed-priced option could not be exercised); see also Bertram, 603 N.W.2d at 571-72 (discussing cases and affirming finding that the parties intended that the optionee/holder forfeit its fixed-price option if it was not exercised before the optionee/holder received notice of the third party's offer); M&M Oil, 640 P.2d at 320-21 (discussing cases and holding that where the contract does not specify which provision takes precedence, the optionee/holder forfeits its fixed-price option if it is not exercised before the optionee/holder receives notice of the third party's offer).

233 See Markert v. Williams, 874 S.W.2d 353, 358 (Tex. App.-- Houston [1st Dist.] 1994, writ denied). Three other Texas cases have involved dual options. See Sinclair Ref. Co. v. Allbritton, 218 S.W.2d 185, 188-89 (Tex. 1949) (holding that the optionee/holder properly exercised the fixed-price option before it received notice of third party's offer); Durrett Dev., Inc. v. Gulf Coast Concrete, L.L.C., No. 14-07-01062-CV, 2009 WL 2620506, at *6 (Tex. App.--Houston [14th Dist.] Aug. 27, 2009, no. pet. h.) (mem. op.) (holding that, under the provisions' unambiguous language, the optionee/holder could exercise the fixed-price option immediately after receiving notice of the third party's offer); Elec. Reliability Council of Tex., Inc. v. Met Ctr. Partners-4, Ltd., No. 03-04-00109-CV, 2005 WL 2312710, at *11 (Tex. App.-- Austin Sept. 22, 2005, no pet.) (involving a lease that expressly provided that the fixed-priced option terminated upon the optionee/holder's receipt of notice of a third party's offer).

234 See, e.g., Bayer v. Showmotion, Inc., 973 A.2d 1229, 1245 (Conn. 2009) (ten-day time period); Old Port Cove Holdings, Inc. v. Old Port Cove Condo. Ass'n One, Inc., 986 So. 2d 1279, 1281 (Fla. 2008) (thirty-day time period); Barco Holdings, L.L.C. v. Terminal

Inv. Corp., 967 So.2d 281, 284 (Fla. Dist. Ct. App. 2007) (seven-day time period); Collins v. Collins, No. 13-07-240-CV, 2009 WL 620470, at *1 (Tex. App.--Corpus Christi Mar. 12, 2009, pet. denied) (not designated for publication) (five-day time period).

235 See cases cited supra note 7.

236 E.g., Egbert R. Smith Trust v. Homer, 731 N.W.2d 810, 812-13 (Mich. Ct. App. 2007), aff'd, 745 N.W.2d 754 (Mich. 2008); Glick v. Chocorua Forestlands L.P., 949 A.2d 693, 701 (N.H. 2008); Riley v. Campeau Homes, Inc., 808 S.W.2d 184, 188-89 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd); Henderson v. Nitschke, 470 S.W.2d 410, 414 (Tex. Civ. App.-- Eastland 1971, writ ref'd n.r.e.); Mobil Oil Guam Inc. v. Tendido, No. CVA03-006, 2004 WL 1013367, at *10 (Guam May 7, 2004); But see Lin Broad. Corp. v. Metromedia 542 N.E.2d 629, 630-31 (N.Y. 1989) (holding that the holder could not exercise the first-refusal right after the third party's offer was withdrawn).

237 See Holland v. Fleming, 728 S.W.2d 820, 823 (Tex. App.--Houston [1st Dist.] 1987, writ ref'd n.r.e.) ("Upon executing the sales contract, the [grantor] had a reasonable amount time within which to notify [the holder] of the terms of the proposed sale. The earnest money contract was in effect for only several days before it was canceled by mutual agreement. When the sales contract ended, that terminated the appellant's obligation to give notification to the [holder]. There was no longer a pending sale, and the preemptive right of purchase never matured into an enforceable option.").

238 E.g., FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P., No. 2-08-321-CV, 2009 WL 4114140, at *5 (Tex. App.--Fort Worth Aug. 27, 2009, pet. denied), withdrawn, 301 S.W.3d 787 (Tex. App.--Fort Worth 2009, pet. filed) ("Once the property owner has given notice of his intent to sell on the terms contained in the third-party offer, the terms of the option cannot be changed for as long as the option is binding on the property owner." (quoting City of Brownsville v. Golden Spread Elec. Coop., Inc., 192 S.W.3d 876, 880 (Tex. App.--Dallas 2006, pet. denied))); Nat'l Adver. Co. v. Potter, No. 01-06-01042-CV, 2008 WL 920338, at *3 (Tex. App.--Houston [1st Dist.] Apr. 3, 2008, pet. denied) (mem. op.) (same); Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 526 (Tex. App.--Amarillo 1998, pet. denied) (same). Of course, if the notice contains an error, the grantor should be able to correct it.

239 Perritt Co. v. Mitchell, 663 S.W.2d 696, 699 (Tex. App.--Fort Worth 1983, writ ref'd n.r.e.) (citation omitted); accord Minton v. Crawford, 719 So. 2d 743, 746 (La. Ct. App. 1998) ("Once the right of first refusal was violated, [the holder] had a cause of action which could not be 'undone' by the subsequent actions of [the grantor]."); Long v. Wayble, 618 P.2d 22, 25 (Or. Ct. App. 1980) (holding that the grantor's listing of property for sale with real-estate broker triggered fixed-price, first-refusal right and grantor could not "later circumvent that obligation by withdrawing the property from the market").

240 See Abraham Inv., 968 S.W.2d at 526 (holding that although the holder's counteroffer before the expiration of the time to exercise the first-refusal right did not terminate the right, the holder "still needed to accept according to the terms and manner prescribed"); cf. Corbin, supra note 1, §11.8, at 530 (noting that the optionee's counteroffer before the option's expiration does not terminate the option).

241 E.g., Green v. First Am. Bank & Trust, 511 So. 2d 569, 575 (Fla. Dist. Ct. App. 1987) ("We...hold that the original offer contained in [the holder's] lawyer's letter...was not a sufficient exercise of the [first-refusal right] because, as [the holder] admits, he never intended to match the [third party's] offer...."); Seessel Holdings, Inc. v. Flemings Cos., 949 F. Supp. 572, 578 (W.D. Tenn. 1996) ("[M]erely electing to exercise a first-refusal right is not sufficient if a right holder subsequently refuses to timely enter into a contract matching the terms of the third-party agreement."); Abraham Inv., 968 S.W.2d at 525-26 (holding that the holder's exercise of a first-refusal right was invalid when the holder did not intend to perform the triggering offer's terms).

242 663 N.W.2d 169, 170-71 (N.D. 2003).

243 Id. at 171.

244 Id.

245 Id.

246 Id.

247 Id. at 172-73, 175; accord Harper v. Great Salt Lake Council, Inc., 976 P.2d 1213, 1218 (Utah 1999). This would not be the case, however, if the third party and grantor entered into a contract conditioned on the holder matching the contract's terms exactly. See Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 528 (Tex. App.--Amarillo 1998, pet. denied); see also infra text accompanying notes 298-304.

248 See, e.g., 6500 Cedar Springs, L.P. v. Collector Antique, Inc., No. 05-98-00386-CV, 2000 WL 1176586, at *4 (Tex. App.--Dallas Aug. 21, 2000, no pet.) (not designated for publication) (involving a first-refusal right in a commercial lease); Imco Oil & Gas Co. v. Mitchell Energy Corp., 911 S.W.2d 916, 921 (Tex. App.--Fort Worth 1995, no writ) (involving a first-refusal right in a joint operating agreement); Foster v. Bullard, 496 S.W.2d 724, 736 (Tex. Civ. App.--Amarillo 1973, writ ref'd n.r.e.) (involving a first-refusal right in a deed); see also Foster v. Hanni, 841 P.2d 164, 171 (Alaska 1992) (involving first-refusal right in a lease); Sand v. London & Co., 121 A.2d 559, 562 (N.J. Super. Ct. App. Div. 1956) (involving a first-refusal right in a lease); Cipriano v. Glen Cove Lodge #1458, B.P.O.E., 801 N.E.2d 388, 390-93 (N.Y. 2003) (involving a first-refusal right in a real-estate sales contract).

249 E.g., Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 596 (Tex. 1992); Zale Corp. v. Decorama, Inc., 470 S.W.2d 406, 408 (Tex. Civ. App.--Waco 1971, writ ref'd n.r.e.); Restatement (Second) of Contracts §§318, 320 (1981); see also Tex. Bus. & Com. Code Ann. §2.210(b) (Vernon 2009) (providing that, under the Uniform Commercial Code, all sales contracts are assignable unless the assignment would materially change the other party's duties, materially increase the burden or risk imposed on the other party, or materially impair the other party's chance of obtaining return performance).

The principal exception to the general assignability rule is that "a contract that relies on the personal trust, skill, character or credit of the parties, may not be assigned without the consent of the parties." E.g., Crim Truck & Tractor, 823 S.W.2d at 596.

Some jurisdictions hold that first-refusal rights are personal, and, therefore, not assignable, to avoid a conflict with the rule against perpetuities. E.g., Park Station L.P. v. Bosse, 835 A.2d 646, 653 (Md. 2003); Jones v. Stahr, 746 N.W.2d 394, 399 (Neb. Ct. App. 2008); Metro. Transp. Auth. v. Bruken Realty Corp., 492 N.E.2d 379, 384 (N.Y. 1986).

250 Walker v. Horine, 695 S.W.2d 572, 578 (Tex. App.--Corpus Christi 1985, no writ.) (holding written permission is not required for assignment).

251 E.g., Zale Corp., 470 S.W.2d at 408.

252 Tarrant County Appraisal Dist. v. Colonial Country Club, 767 S.W.2d 230, 235 (Tex. App.--Fort Worth 1989, writ denied); accord 718 Assocs., Ltd. v. Sunwest N.O.P., Inc., 1 S.W.3d 355, 364 (Tex. App.--Waco 1999, pet. denied).

253 E.g., Inwood N. Homeowners' Ass'n v. Harris, 736 S.W.2d 632, 635 (Tex. 1987); First Permian, L.L.C. v. Graham, 212 S.W.3d 368, 372 (Tex. App.--Amarillo 2006, pet. denied); Ehler v. B.T. Suppenas Ltd., 74 S.W.3d 515, 520 (Tex. App.--Amarillo 2002, pet. denied).

254 E.g., Tarrant County Appraisal Dist., 767 S.W.2d at 235.

255 E.g., First Permian, 212 S.W.3d at 372; McMillan v. Dooley, 144 S.W.3d 159, 185 (Tex. App.--Eastland 2004, pet. denied); Sanchez v. Dickinson, 551 S.W.2d 481, 485 (Tex. Civ. App.--San Antonio 1977, no writ); Foster v. Bullard, 496 S.W.2d 724, 736-37 (Tex. Civ. App.--Amarillo 1973, writ ref'd n.r.e.); Stone v. Tigner, 165 S.W.2d 124, 127 (Tex. Civ. App.-- Galveston 1942, writ ref'd).

Courts from other jurisdictions are split on the issue. Some, like Texas courts, hold that first-refusal rights can be real covenants. E.g., Sherwood Ford, Inc. v. Ford Motor Co., 860 F. Supp. 659, 662 (E.D. Mo. 1994) (applying Missouri law); Coordinated Fin. Planning Corp. v. Steffan, 65 B.R. 711, 712 (B.A.P. 9th Cir. 1986) (applying California law); Tadros v. Middlebury Med. Ctr., Inc., 820 A.2d 230, 236 (Conn. 2003); No-Pink, Inc. v. Ellison, No. 215457, 2001 WL 721397, at *2 (Mich. Ct. App. Feb. 27, 2001) (unpublished opinion); L&M Corp. v. Loader, 688 P.2d 448, 449 (Utah 1984); Mitchell v. Mitchell, No. 93-3312, 1994 WL 463957, at *3 n.1 (Wis. Ct. App. Aug. 30, 1994) (unpublished disposition). Others, however, hold that first-refusal rights are not real covenants because they do not touch or concern the land as they neither burden the grantor's land nor benefit the holder's land. E.g., In re Fleishman, 138 B.R. 641, 645 (Bankr. E.D. Mass. 1992) (applying Massachusetts law); Ricketson v. Bankers First Sav. Bank, 503 S.E.2d 297, 298-300 (Ga. Ct. App. 1998); Rosewood Constr. Corp. v. Mass. Youth Soccer Ass'n, No. 2008-01411, 2008 WL 5505483, at *5 (Mass. Super. Ct. Dec. 18, 2008); Clarke v. Caldwell, 521 N.Y.S.2d 851, 854 (N.Y. App. Div. 1987); Feider v. Feider, 699 P.2d 801, 803-04 (Wash. Ct. App. 1985).

256 See Sanchez, 551 S.W.2d at 485; Bullard, 496 S.W.2d at 736-37; Stone, 165 S.W.2d at 127.

257 E.g., Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 911 (Tex. 1982) (discussing requirement generally); Berkman v. City of Keene, No. 10-08-00073, 2009 Tex. App. LEXIS 5494, at *10-11 (Tex. App.--Waco July 15, 2009, no. pet. h.); Feider, 699 P.2d at 803-04 (discussing requirement in the context of a first-refusal right); Howard R. Williams, Restrictions on the Use of Land: Covenants Running with the Land at Law, 27 Tex. L. Rev. 419, 429 (1949) (discussing requirement generally).

258 First Permian, 212 S.W.3d at 371-72 (refusing to enforce a first-refusal right because the holder no longer owned an interest in land).

259 Williams, supra note 257, at 453 (concluding that, under Texas law, a covenant runs with the land "so long [the] burden touches or concerns the covenantor's land irrespective whether [a] benefit touches or concerns the [covenantee's] land"); Restatement (Third) of Prop.: Servitudes §3.2 (2000) ("Neither the burden nor the benefit of a covenant is required to touch or concern the land in order for the covenant to be valid as a servitude.").

260 Compare In re El Paso Refinery, L.P., 302 F.3d 343, 356-57 (5th Cir. 2002) (noting the lack of clarity and pointing out that Westland Oil Development Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 911 (Tex. 1982), and Wimberly v. Lone Star Gas Co., 818 S.W.2d 868, 872 (Tex. App.--Fort Worth 1991, writ denied), can be read as dispensing with the benefit requirement, and enforcing covenants upon a burden only showing), with Berkman, 2009 Tex. App. LEXIS 5494, at *10 n.5 ("Our Supreme Court has not adopted the view of the Restatement (Third), and absent guidance from that Court, we decline to do so.").

261 212 S.W.3d 368, 373 (Tex. App.--Amarillo 2006, pet. denied).

262 Id. at 369.

263 Id. at 369-70.

264 Id. at 370.

265 Id.

266 Id.

267 Id. at 370-71.

268 Id. at 373.

269 Id. at 371-72.

270 Id. at 372.

271 Id. at 372. This is a reasonable way to distinguish McMillan because the covenant's nature as a real or personal covenant was irrelevant to Johnson's ability to enforce it. Id. Nonetheless, the distinction ignores the McMillan court's clear statement that Johnson's first-refusal right ran with the land. Id. at 373.

272 Id. at 370-71.

273 See 125 Tex. 363, 371, 83 S.W.2d 318, 321-22 (1935).

274 Ayres v. Townsend, 598 A.2d 470, 474 (Md. 1991); Pace v. Culpepper, 347 So. 2d 1313, 1317-18 (Miss. 1977); Lake of the Woods Ass'n v. McHugh, 380 S.E.2d 872, 875 (Va. 1989); cf. Madera Prod. Co. v. Atl. Richfield Co., 107 S.W.3d 652, 660 (Tex. App.--Texarkana 2003, no pet.) (holding that an option creates an interest in land); Hitchcock Props., Inc. v. Levering, 776 S.W.2d 236, 238-39 (Tex. App.--Houston [1st Dist.] 1989, writ denied) (same).

275 551 S.W.2d 481, 485 (Tex. Civ. App.--San Antonio 1977, no writ).

276 165 S.W.2d 124, 127 (Tex. Civ. App.--Galveston 1942, writ ref'd).

277 First Permian, 212 S.W.3d at 372. The court in First Permian also distinguished Westland Oil Development Corp. v. Gulf Oil Corp., 637 S.W.2d 903 (Tex. 1982), on the ground that the covenantee held an interest in land--an overriding royalty. See First Permian, 212 S.W.3d at 372-73. However, the Texas Supreme Court, in holding that the covenant in Westland Oil Development Corp. ran with the land, did not rely on that fact, did not explain how the covenant benefitted the covenantee's overriding royalty, and clearly suggested that a covenant can run with the land only if it burdens the covenantor's land. See Westland Oil Dev., 637 S.W.2d at 911; accord In re El Paso Refinery, L.P., 302 F.3d 343, 357 (5th Cir. 2002) (pointing out that Westland Oil Development can be read as dispensing with the benefit requirement, and enforcing covenants upon a burden only showing).

278 See First Permian, 212 S.W.3d at 372.

279 See id.

280 Davis v. Anthony, No. 97 CO 19, 1998 WL 896453, at *2 (Ohio Ct. App. Dec. 21, 1998) (quoting Stratman v. Sheetz, 573 N.E.2d 776, 778 (Ohio Ct. App. 1989)); accord Mobil Exploration & Producing N. Am., Inc. v. Graham Royalty Ltd., 910 F.2d 504, 507 (8th Cir. 1990) (applying Arkansas law) (same); Tadros v. Middlebury Med. Ctr., Inc., 820 A.2d 230, 244 (Conn. 2003) (right of refusal runs with the land); McMillan v. Dooley, 144 S.W.3d 159, 164 (Tex. App.--Eastland 2004, pet. denied) (first-refusal right runs with the land because it is binding on successors and assigns); Sanchez v. Dickinson, 551 S.W.2d 481, 484-85 (Tex. Civ. App.--San Antonio 1977, no writ) (same); Mitchell v. Mitchell, No. 93-3312, 1994 WL 463957, at *3 n.1 (Wis. Ct. App. Aug. 30, 1994) (same); see Mulvey v. Mobil Producing Tex. & N.M., Inc., 147 S.W.3d 594, 607 (Tex. App.--Corpus Christi 2004, pet. denied) (holding that assignee of joint-operating agreement had standing to assert claim under the agreement's first-refusal right).

281 Specific performance is an equitable remedy that compels a party to perform a contract as promised. E.g., S. Plains Switching, Ltd. v. BNSF Ry. Co., 255 S.W.3d 690, 703 (Tex. App.--Amarillo 2008, pet. denied); Estate of Griffin v. Sumner, 604 S.W.2d 221, 225 (Tex. Civ. App.--San Antonio 1980, writ ref'd n.r.e.). It is usually available when recovery of money damages for the contract's breach is inadequate to compensate the non-breaching party for the loss of its benefit of the bargain, and the contract's subject matter is real estate or personal property having a special, peculiar, or unique character. E.g., DiGiuseppe v. Lawler, 269 S.W.3d 588, 593 (Tex. 2008) (specific performance granted to enforce real property contract); Stafford v. S. Vanity Magazine, Inc., 231 S.W.3d 530, 535 (Tex. App.--Dallas 2007, pet. denied) (specific performance granted to enforce stock purchase agreement for stock in closely held corporation that had no ascertainable value); Scott v. Sebree, 986 S.W.2d 364, 368-69 (Tex. App.--Austin 1999, pet. denied); Am. Apparel Prods. v. Brabs, Inc., 880 S.W.2d 267, 269 (Tex. App.--Houston [14th Dist.] 1994, no writ) ("Specific performance of a contract involving personal property may be granted where the property has a special, peculiar, or unique value or character and the plaintiff would not be adequately compensated for his loss by money damages."); Madariaga v. Morris, 639 S.W.2d 709, 712 (Tex. App.--Tyler 1982, writ ref'd n.r.e.) (specific performance granted to enforce contract containing option to purchase business that included goodwill and a product formula).

A decree of specific performance may be worded in the negative to enjoin a contracting party from violating its contract. E.g., Cytogenix, Inc. v. Waldroff, 213 S.W.3d 479, 487 (Tex. App.--Houston [1st Dist.] 2006, pet. denied); Fuller v. Walter E. Heller & Co., 483 S.W.2d 348, 351 (Tex. Civ. App.--Dallas 1972, no writ).

282 See Briggs v. Sylvestri, 714 A.2d 56, 60 (Conn. Ct. App. 1998); C&J Delivery, Inc. v. Vinyard & Lee & Partners, Inc., 647 S.W.2d 564, 569 (Mo. Ct. App. 1983); Riley v. Campeau Homes (Tex.), Inc., 808 S.W.2d 184, 188 (Tex. App.--Houston [14th Dist.] 1991, writ dism'd); Corbin, supra note 1, §11.3, at 471, 483.

283 E.g., Abraham Inv. Co. v. Payne Ranch, Inc., 968 S.W.2d 518, 527 (Tex. App.--Amarillo 1998, pet. denied); see also Koch Indus., Inc. v. Sun Co., 918 F.2d 1203, 1211 (5th Cir. 1990) (applying Texas law); Sherwood Ford, Inc. v. Ford Motor Co., 860 F. Supp. 659, 663 (E.D. Mo. 1994) (applying Missouri law); Meyer v. Warner, 448 P.2d 394, 397 (Ariz. 1968); Atchison v. City of Englewood, 568 P.2d 13, 21 (Colo. 1977); C&J Delivery, 647 S.W.2d at 569; Larson Operating Co. v. Petroleum, Inc., 84 P.3d 626, 632 (Kan. Ct. App. 2004); Hancock v. Dusenberry, 715 P.2d 360, 365 (Idaho 1986); No-Pink, Inc. v. Ellison, No. 215457, 2001 WL 721397, at *3 (Mich. Ct. App. Feb. 27, 2001); Winberg v. Cimfel, 532 N.W.2d 35, 41 (Neb. 1995); Glick v. Chocorua Forestlands L.P., 949 A.2d 693, 701 (N.H. 2008); H.G. Fabric Discount, Inc. v. Pomerantz, 515 N.Y.S.2d 823, 825 (App. Div. 1987); Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 543 (Tex. App.--Waco 2008, pet. denied); Chapman v. Mut. Life Ins. Co., 800 P.2d 1147, 1150-51 (Wyo. 1990).

284 Abraham Inv., 968 S.W.2d at 527; Riley, 808 S.W.2d at 188; Briggs, 714 A.2d at 60; see Digiuseppe, 269 S.W.3d at 600 (discussing specific performance in general).

285 E.g., Digiuseppe, 269 S.W.3d at 594; Stafford, 231 S.W.3d at 535; Riley v. Powell, 665 S.W.2d 578, 581 (Tex. App.--Fort Worth 1984, writ ref'd n.r.e.).

286 See Koch, 918 F.2d at 1214; Meyer, 448 P.2d at 397; Phipps v. CW Leasing, Inc., 923 P.2d 863, 866 (Ariz. Ct. App. 1996); Atchison, 568 P.2d at 22; Anderson v. Armour & Co., 473 P.2d 84, 89 (Kan. 1970); Barela v. Locer, 708 P.2d 307, 311 (N.M. 1985); C&J Delivery, 647 S.W.2d at 569; Shell v. Austin Rehearsal Complex, Inc., No. 03-97-0411-CV, 1998 WL 476728, at *11 (Tex. App.--Austin Aug. 13, 1998, no pet.) (not designated for publication); Corbin, supra note 1, §11.3, at 471-72, 483.

A holder generally cannot recover both specific performance and actual damages. E.g., Paciwest, Inc. v. Warner Alan Props., 266 S.W.3d 559, 574-75 (Tex. App.--Fort Worth 2008, no pet.); Scott, 986 S.W.2d at 370. In appropriate circumstances, however, a holder, in addition to specific performance, may recover consequential damages caused by the late performance. E.g., Paciwest, 266 S.W.3d at 575; Heritage Hous. Corp. v. Ferguson, 674 S.W.2d 363, 365-66 (Tex. App.--Dallas 1984, writ ref'd n.r.e.). Such compensation is not considered damages for the contract breach, but instead equalizes losses caused by the delay by offsetting them with money damages. For example, the holder may recover the property's rental value from the time of its demand on the grantor or the third party for performance and the tender of the purchase price or damages for increased construction or financing costs. See, e.g., Paciwest, 266 S.W.3d at 574-75.

287 E.g., Barela, 708 P.2d at 311.

288 Phillips v. Phillips, 820 S.W.2d 785, 788 (Tex. 1991); accord Koch, 918 F.2d at 1214 (same).

289 Continental Holdings, Ltd. v. Leahy, 132 S.W.3d 471, 475 (Tex. App.--Eastland 2003, no pet.) (citing Frost Nat. Bank v. Heafner, 12 S.W.3d 104, 111 n.5 (Tex. App.--Houston [1st Dist.] 1999, pet. denied)).

290 E.g., Baylor Univ. v. Sonnichsen, 221 S.W.3d 632, 636 (Tex. 2007); Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 816 (Tex. 1997).

291 See Koch, 918 F.2d at 1214; Miga v. Jenson, 96 S.W.3d 207, 215 (Tex. 2001) (holding that the measure of damages for an option's breach "is the traditional one: 'the difference between the price contracted to be paid and the value of the article when it should [have been] delivered'" (quoting Randon v. Barton, 4 Tex. 289, 293 (1849))).

292 Atchison v. City of Englewood, 568 P.2d 13, 22 (Colo. 1977); Anderson v. Armour & Co., 473 P.2d 84, 89 (Kan. 1970); Arlington State Bank v. Colvin, 545 N.E.2d 572, 575 (Ind. Ct. App. 1989). Because the third party often pays the market price for the burdened property, the holder may have no benefit of the bargain damages. In such an event, the holder may seek to recover its out-of-pocket loss of funds or reliance damages. E.g., Restatement (Second) of Contracts §§347, 349, 356 (1981); 2 William V. Dorsaneo III, Texas Litigation Guide §21.02[2], at 21-27 (2008); 2 Samuel Williston, A Treatise on the Law of Contracts §§64.1, 64.2 (4th ed. 2003).

293 E.g., Baylor, 221 S.W.3d at 636; Arthur Andersen, 945 S.W.2d at 817.

294 See Simulnet E. Assocs. v. Ramada Hotel Operating Co., Nos. 95-16339 & 95-16340, 1997 U.S. App. LEXIS 41152, at *13-15 (9th Cir. July 31, 1997) (applying Nevada law) (affirming a judgment awarding the holder lost profits for its first-refusal right's breach); Shell v. Austin Rehearsal Complex, Inc., No. 03-97-0411-CV, 1998 WL 476728, at *11 (Tex. App.--Austin Aug. 13, 1998, no pet.) (not designated for publication) (awarding lost profits from the property's use); see also Ryan v. Thurmond, 481 S.W.2d 199, 206 (Tex. Civ. App.--Corpus Christi 1972, writ ref'd n.r.e.) (awarding damages for loss of the fair rental value of a building to be constructed).

295 E.g., Paciwest, Inc. v. Warner Alan Props., 266 S.W.3d 559, 574-75 (Tex. App.--Fort Worth 2008, no pet.).

296 Koch, 918 F.2d at 1214 (quoting Olson v. Bayland Pub., Inc., 781 S.W.2d 659, 664 (Tex. App.--Houston [1st Dist.] 1989, writ denied) (citations omitted)); see also Amerada Hess Corp. v. Schwartz, No. 14-93-0157-CV, 1995 Tex. App. LEXIS 1819, at *5 (Tex. App.--Houston [14th Dist.] Aug. 10, 1995, no writ).

297 See Kjesbo v. Ricks, 517 N.W.2d 585, 590-91 (Minn. 1994); Praxair, Inc. v. Airgas, Inc., No. 98-CVS-8571, 1999 NCBC LEXIS 9, at *19-21 (N.C. Super. Ct. Oct. 20, 1999). To the extent that West Texas Transmission's good-faith requirement applies under Texas law, a third party, who induces the grantor to include a commercially unreasonable or bad-faith term or condition in the third party's contract conceivably could be liable to the holder for tortious interference. E.g., David A. Bramble, Inc. v. Thomas, 914 A.2d 136, 147 (Md. 2007) ("In some cases, there have been arguments made that the third party, for its own conduct [in connection with the breach of a good-faith requirement], should be liable for intentional interference with the preemptioner's right of first refusal." (citing Prince v. Elm Inv. Co., 649 P.2d 820, 821 (Utah 1982))).

298 Compare Seelbach v. Clubb, 7 S.W.3d 749, 756-57 (Tex. App.-- Texarkana 1999, pet. denied) (holding that exemplary damages are recoverable for tortious interference with contract), and Armandariz v. Mora, 553 S.W.2d 400, 407 (Tex. Civ. App.--El Paso 1977, writ ref'd n.r.e.) (same), with Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex. 1986) (holding that exemplary damages are not recoverable in a contract action even if the breach was intentional or malicious), and Restatement (Second) of Contracts §355 (1981) (concluding that exemplary damages are not recoverable for a contract breach).

299 968 S.W.2d 518, 522-23 (Tex. App.--Amarillo 1998, no writ).

300 Id.

301 Id.

302 Id. at 524, 527.

303 Id. at 528. See also LDC-728 Milwaukee, L.L.C. v. Raettig, 727 N.W.2d 82, 86-87 (Wis. Ct. App. 2006) (holding that the holder breached a first-refusal right when he exercised it knowing that he could not purchase the burdened property). The grantor and holder are most at risk if the grantor's contract with the third party is conditioned on the holder's purchase on terms identical to those in the third party's contract.

304 Another ground on which a first-refusal right's validity can be attacked is lack of consideration. E.g., Serenic Software, Inc. v. Protean Techs., Inc., No. CV-04-415-LMB, 2007 WL 1366547, at *12 (D. Idaho 2007) (applying Idaho law) (unreported mem. op.) ("[T]he alleged right of first-refusal agreement must fail for lack of consideration.").

305 Tex. Bus. & Com. Code Ann. §26.01(b)(4) (Vernon 2009); Tex. Prop. Code Ann. §5.072(a) (Vernon 2004); Reiland v. Patrick Thomas Props., Inc., 213 S.W.3d 431, 436-37 (Tex. App.--Houston [1st Dist.] 2006, no pet.); see also Rolfe v. King, No. 05-03-00357-CV, 2004 WL 784626, at *2 (Tex. App.--Dallas Mar. 29, 2004, no pet.) (unreported mem. op.); Foster v. Bullard, 496 S.W.2d 724, 733 (Tex. Civ. App.--Austin 1973, writ ref'd n.r.e.); Cherry v. Salinas, 355 S.W.2d 833, 834 (Tex. Civ. App.--San Antonio 1962, writ ref'd n.r.e.); cf. Watkins v. Arnold, 60 S.W.2d 476, 477 (Tex. Civ. App--Texarkana 1933, writ ref'd) (holding that option contracts relating to land are within the statute of frauds).

306 E.g., Tex. Bus. & Com. Code Ann. §26.01(b)(5); Tex. Prop. Code Ann. §5.021; 2616 S. Loop L.L.C. v. Health Source Home Care, Inc., 201 S.W.3d 349, 355 (Tex. App.--Houston [14th Dist.] 2006, no. pet.).

307 Quigley v. Bennett, 227 S.W.3d 51, 54 (Tex. 2007) (involving royalty interest); Long Trusts v. Griffin, 222 S.W.3d 412, 416 (Tex. 2006) (involving assignment of oil and gas interests).

308 Tex. Bus. Com. Code Ann. §2.201(a); E. Hill Marine, Inc. v. Rinker Boat Co., 229 S.W.3d 813, 818 (Tex. App.--Fort Worth 2007, no pet.). The Texas Uniform Commercial Code defines "goods:"
[A]ll things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities...and things in action. 'Goods' also includes the unborn young of animals and growing crops and other identified things attached to realty...."
Tex. Bus. & Com. Code §2.105(a).

309 The grantor or third party must plead the statute of frauds as an affirmative defense. Tex. R. Civ. P. 94; First Nat'l Bank v. Zimmerman, 442 S.W.2d 674, 677 (Tex. 1969); Santa Fe Petroleum, L.L.C. v. Star Canyon Corp., 156 S.W.3d 630, 641 (Tex. App.--Tyler 2004, no pet.).

310 E.g., Troxel v. Bishop, 201 S.W.3d 290, 300 (Tex. App.--Dallas 2006, no pet.); Enochs v. Brown, 872 S.W.2d 312, 318 (Tex. App.--Austin 1994, no writ).

311 Tex. Bus. & Com. Code Ann. §26.01(a)(1).

312 Id. §26.01(a)(2).

313 E.g., Haase v. Glazner, 62 S.W.3d 795, 798 (Tex. 2001).

314 E.g., BACM 2001-1 San Felipe Rd. L.P. v. Trafalgar Holdings I, Ltd., 218 S.W.3d 137, 144 (Tex. App.--Houston [14th Dist.] 2007, no pet.); Dobson v. Metro Label Corp., 786 S.W.2d 63, 65 (Tex. App.--Dallas 1990, no writ).

315 Tex. Bus. & Com. Code Ann. §26.01(b)(4) (writing requirement for "a contract for the sale of real estate"); Tex. Prop. Code Ann. §5.021 (Vernon 2004) (writing requirement for property contracts); Rolfe v. King, No. 05-03-00357-CV, 2004 WL 784626, at *2 (Tex. App.--Dallas Mar. 29, 2004, no pet.) (mem. op.); Garner v. Redeaux, 678 S.W.2d 124, 126 (Tex. App.-- Houston [14th Dist.] 1984, writ ref'd n.r.e.).

316 See, e.g., Reiland v. Patrick Thomas Props., Inc., 213 S.W.3d 431, 437-38 (Tex. App.--Houston [1st Dist.] 2006, no pet.) (mem. op.) (holding a first-refusal right void under the statute because it contained an inadequate land description); Dunlop-Swain Tire Co. v. Simons, 450 S.W.2d 378, 380-81 (Tex. Civ. App.--Dallas 1970, writ ref'd n.r.e.) (same).

317 Reiland, 213 S.W.3d at 436 (quoting Morrow v. Shotwell, 477 S.W.2d 538, 539 (Tex. 1972)).

318 See Brenner v. Duncan, 27 N.W.2d 320, 321 (Mich. 1947); Barling v. Horn, 296 S.W.2d 94, 96-97 (Mo. 1956).

319 E.g., Steinberg v. Sachs, 837 So. 2d 503, 505-06 (Fla. Dist. Ct. App. 2003); Brenner, 27 N.W.2d at 322; Barling, 296 S.W.2d at 97; Albright, supra note19, at 806.

320 E.g., Radio WEBS, Inc. v. Tele-Media Corp. 292 S.E.2d 712, 713 n.2 (Ga. 1982) ("Where no price is stated when the right is granted, the offer of the third party supplies the terms under which the right of first refusal may be exercised."); Brownies Creek Collieries, Inc. v. Asher Coal Mining Co., 417 S.W.2d 249, 252 (Ky. 1967) ("A contract provision giving simply the 'right of first refusal'...without qualifying terms means...that the holder has the right to elect to take the property on the same price and on the same terms and conditions as those of an offer by a third party that the owner is willing to accept."); Peet v. Randolph, 33 S.W.3d 614, 618 (Mo. Ct. App. 2000) ("[M]issing terms such as the price of the land or the duration do not render [a first-refusal] clause unenforceable."); Corbin, supra note 1, §11.3, at 482-83 (same); 6 American Law of Property §26.65, at 507 (1952) ("If no price is specified in the [first-refusal right,] the natural interpretation is that the offeror's price must be paid upon exercise of the pre-emption."). But see Duke v. Whatley, 580 So. 2d 1267, 1274-75 (Miss. 1991) (affirming trial court's denial of specific performance because first-refusal did not specifically provide a mechanism for determining holder's purchase price); Hood v. Hawkins, 478 A.2d 181, 186-87 (R.I. 1984) (same); Rolfs v. Mason, 119 S.E.2d 238, 242 (Va. 1961) (same).

321 Potter v. Couch, 141 U.S. 296, 315 (1891) (holding that "the right of alienation is an inherent and inseparable quality of an estate in fee simple").

322 E.g., Procter v. Foxmeyer Drug Co., 884 S.W.2d 853, 859 (Tex. App.--Dallas 1994, no writ). Texas courts look to the three Restatements on Property to determine whether an alleged restraint on alienation is unreasonable and, therefore, unenforceable. E.g., Navasota Res., L.P. v. First Source Tex., Inc., 249 S.W.3d 526, 537 (Tex. App.--Waco 2008, pet. denied) (citing cases).
Section 404 of the Restatement of Property defines a restraint on alienation, in part:
[A]n attempt by an otherwise effective conveyance or contract to cause a later conveyance...to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey; or...to terminate or subject to termination all or part of the property interest conveyed.
Restatement of Prop. §§404(1)(b)-(c) (1944) (quoted with approval in Navasota, 249 S.W.3d at 537-38).

323 Albright, supra note 19, at 807.

324 Procter, 884 S.W.2d at 859 ("[A] right of first refusal is not a restraint on alienation if the terms of the right are reasonable.").

325 Forderhause v. Cherokee Water Co., 623 S.W.2d 435, 439 (Tex. Civ. App.--Texarkana 1981), rev'd on other grounds, 641 S.W.2d 522, 525 (Tex. 1982); accord Navasota, 249 S.W.3d at 538; Perritt Co. v. Mitchell, 663 S.W.2d 696, 698-99 (Tex. App.--Fort Worth 1983, writ ref'd n.r.e.); Sibley v. Hill, 331 S.W.2d 227, 229 (Tex. Civ. App.--El Paso 1960, no writ); Restatement (Third) of Prop.: Servitudes §3.4 cmt. f (2000); Restatement (Second) of Prop. §4.4 (1983); Restatement of Prop. §413 cmt. 3 (1944); Corbin, supra note 1 §11.3, at 484-45; Albright, supra note 19, at 807; Reasoner, supra note 19, at 60-65.
One Texas case, Gray v. Vandver, 623 S.W.2d 172, 174 (Tex. App.--Waco 1981, writ denied), without considering the many other Texas and non-Texas cases to the contrary, incorrectly held that a non-fixed-price, first-refusal right constituted an unreasonable restraint on alienation.

326 Iglehart v. Phillips, 383 So. 2d 610, 615-16 (Fla. 1980) (holding a fixed-price, first-refusal right of unlimited duration void as an unreasonable restraint on alienation); Edgar v. Hunt, 706 P.2d 120, 122 (Mont. 1985) (holding that a fixed-priced, first-refusal right may be invalid if the price becomes disproportionate to the burdened property's market value); see Mo. State Highway Comm'n v. Stone, 311 S.W.2d 588, 590 (Mo. Ct. App. 1958) (same); Metro. Transp. Auth. v. Bruken Realty Corp., 492 N.E.2d 379, 385 (N.Y. 1986) (noting that a fixed-price, first-refusal right is a "far more serious interference with alienability" than an ordinary one); Restatement (Third) of Prop.: Servitudes §3.4 cmt. f (2000) ("If the price at which the right of first refusal may be exercised is fixed, either absolutely, or by reference to a formula, the impact on alienability is greater than if the seller will get the same price whether or not the right is exercised. Stronger justification is required. The duration of such a restraint may be important in determining its

reasonableness."); Albright, supra note 19, at 808 ("A preferential right provision with more restrictive conditions, such as requiring a sale at a specified price, which may be far less than market value, or placing restrictions on prospective purchasers, will probably be held void.").

327 Tex. Const. art. 1, §26 ("Perpetuities...are contrary to the genius of a free government and should never be allowed...."); accord Forderhause, 623 S.W.2d at 438.

328 Kettler v. Atkinson, 383 S.W.2d 557, 561 (Tex. 1964); Brooker v. Brooker, 130 Tex. 27, 38-39, 106 S.W.2d 247, 254 (1937); Albright, supra note 19, at 808-09.

329 Forderhause, 623 S.W.2d at 439; accord Weber v. Tex. Co., 83 F.2d 807, 808 (5th Cir. 1936) (applying Texas law); Perritt, 663 S.W.2d at 698-99; Foster v. Bullard, 496 S.W.2d 724, 735 (Tex. Civ. App.--Amarillo 1973, writ ref'd n.r.e.); Courseview, Inc. v. Phillips Petroleum Co., 258 S.W.2d 391, 393 (Tex. Civ. App.--Galveston, 1953, writ ref'd n.r.e.); see Murphy Exploration & Prod. Co. v. Sun Operating L.P., 747 So. 2d 260, 263 (Miss. 1999) (following Texas law and noting that Texas courts consistently have held that a non-fixed-price, first-refusal right does not violate the rule against perpetuities).

330 Weber, 83 F.2d at 808. Most other jurisdictions also hold that the rule against perpetuities does not apply to non-fixed-price, first-refusal rights. See Corbin, supra note 1, §11.03, at 484-85. Additionally, the Third Restatement of Property, rejecting the Second Restatement's position, exempts the typical first-refusal right from the rule. Compare Restatement (Third) of Prop. Servitudes §3.3 cmt. a (2000) (noting that the rule against perpetuities does not apply to first-refusal rights), with Restatement (Second) of Prop. §4.4 cmt. c (1983) (noting that first-refusal rights are subject to the rule against perpetuities).

331 E.g., Henderson v. Millis, 373 N.W.2d 497, 505 (Iowa 1985); Bullard, 496 S.W.2d at 736-37; Hartnett v. Jones, 629 P.2d 1357, 1364 (Wyo. 1981). Ordinarily, laches is not available when a suit for specific performance has been filed within the four-year limitations period. E.g., Bilotto v. Brown, No. 04-96-00055-CV, 1996 WL 591926, at *2 (Tex. App.--San Antonio Oct. 9, 1996, no writ) (not designated for publication) ("[I]f suit is brought within the statute of limitations, laches will not apply in the absence of estoppel or extraordinary circumstances."); Helsley v. Anderson, 519 S.W.2d 130, 133-34 (Tex. App.--Dallas 1975, no writ) ("[W]hen an alleged cause of action, either legal or equitable comes within any of the specific provisions of the statute of limitations, the equitable defense of laches is inapplicable unless extraordinary circumstances exist...."); Richards v. Combest, 208 S.W.2d 392, 405 (Tex. Civ. App.--Beaumont 1947, writ ref'd n.r.e.) (holding that mere delay by heirs in filing specific performance suit did not bar action filed within four years of the decedent's death).

332 Ordinarily, an action for specific performance of an oral or written contract must be commenced within four years after the cause of action has accrued. Tex. Civ. Prac. & Rem. Code Ann. §§16.004, 16.051 (Vernon 2008); Tex. Bus. & Com. Code Ann. §2.275 (Vernon 2009) (relating to sale of "goods" under the Uniform Commercial Code); Long Trusts v. Griffin, 144 S.W.3d 99, 104 (Tex. App.--Texarkana 2004), aff'd and rev'd in part on other grounds, 222 S.W.3d 412, 416 (Tex. 2006); Helsley, 519 S.W.2d at 134.

333 See Maharishi Sch. of Vedic Sci. v. Olympus Real Estate Corp., No. 05-01-00140-CV, 2002 WL 1263894, at *2 (Tex. App.--Dallas June 7, 2002, pet. denied) (not designated for publication) (holding that a party who seeks specific performance must come into court with clean hands); Gordin v. Shuler, 704 S.W.2d 403, 408 (Tex. App.--Dallas 1985, writ ref'd n.r.e.) (same); Steves v. United Servs. Auto. Ass'n, 459 S.W.2d 930, 933 (Tex. Civ. App.--Beaumont 1970, writ ref'd n.r.e.) (same).

334 E.g., Sel-Lab Mktg., Inc. v. Dial Corp., No. 01 Civ.-9250(SHS), 2002 WL 1974056, at *3 (S.D.N.Y. Aug. 27, 2002) (unreported op.) (applying New York law); A.G.E., Inc. v. Buford, 105 S.W.3d 667, 673-74 (Tex. App.-- Austin 2003, no pet.); Ellis v. Waldrop, 627 S.W.2d 791, 795-96 (Tex. App.--Fort Worth 1982, writ granted); see Henderson, 373 N.W.2d at 504-05; 2 Dorsaneo, supra note 292, §51.03[4][b] (pointing out that waiver is a defense to specific performance).

335 E.g., Henderson, 373 N.W.2d at 504-05 (estoppel); Foster v. Hanni, 841 P.2d 164, 171 (Alaska 1992) (estoppel); Mulvey v. Mobil Producing Tex. & N.M., Inc., 147 S.W.3d 594, 607 (Tex. App.--Corpus Christi 2004, no pet.) (quasi-estoppel); Pearson v. Schubach, 763 P.2d 834, 836 (Wash. Ct. App. 1988) (estoppel); see 2 Dorsaneo, supra note 292, §51.03[4] [b] (pointing out that estoppel is a defense to specific performance).

336 Because a first-refusal right is contractual, the four-year limitations period of Section 16.004 of the Texas Civil Practice & Remedies Code relating to "debts" applies. See, e.g., Elledge v. Friberg-Cooper Water Supply Corp., 240 S.W.3d 869, 870 (Tex. 2007) (holding that breach of contract actions fall within Section 16.004). Of course, if the right relates to "goods" within the meaning of the UCC, the UCC's four-year limitations period governs the claim. See Tex. Bus. & Com. Code Ann. §2.725 (Vernon 2009).

337 E.g., A.G.E., 105 S.W.3d at 673-74; Ellis, 627 S.W.2d at 795-96.

338 E.g., Hanni, 841 P.2d at 170-71; Pearson, 763 P.2d at 836.

339 The triggering of first-refusal rights is discussed supra Part III.

340 E.g., Seureau v. ExxonMobil Corp., 274 S.W.3d 206, 226 (Tex. App.--Houston [14th Dist.] 2008, no pet.); XCO Prod. Co. v. Jamison, 194 S.W.3d 622, 634 (Tex. App.--Houston [14th Dist.] 2006, no pet.). An action's accrual date is a question of law for the court. Moreno v. Sterling Drug, Inc., 787 S.W.2d 348, 351 (Tex. 1990).

341 S.V. v. R.V., 933 S.W.2d 1, 4 (Tex. 1996); Seureau, 274 S.W.3d at 226.

342 S.V., 933 S.W.2d at 4; see Robert K. Wise et al., Negligent Misrepresentation in Texas: The Misunderstood Tort, 40 Tex. Tech L. Rev. 845, 909 (2008) (discussing limitations in general).

343 Goggin v. Grimes, 969 S.W.2d 135, 137 (Tex. App.--Houston [14th Dist.] 1998, no pet.).

344 Trail Enters., Inc. v. City of Houston, 957 S.W.2d 625, 631 (Tex. App.--Houston [14th Dist.] 1997, no pet.).

345 Childs v. Haussecker, 974 S.W.2d 31, 41 n.7 (Tex. 1998); Goggin, 969 S.W.2d at 137.

346 Tex. Civ. Prac. & Rem. Code Ann. §16.004(a)(1)-(3) (Vernon 2002); Via Net v. TIG Ins. Co., 211 S.W.3d 310, 314 (Tex. 2006); Stine v. Stewart, 80 S.W.3d 586, 592 (Tex. 2002). See also authorities cited supra notes 333 and 337.

347 Barker v. Eckman, 213 S.W.3d 306, 311 (Tex. 2006); Stine, 80 S.W.3d at 592; Seureau v. ExxonMobil Corp., 274 S.W.3d 206, 227 (Tex. App.--Houston [14th Dist.] 2008, no pet.).

348 Seureau, 274 S.W.3d at 227; Townewest Homeowners Ass'n v. Warner Commc'n Inc., 826 S.W.2d 638, 640 (Tex. App.--Houston [14th Dist.] 1992, no writ).

349 E.g., Achee v. Port Drum Co., 197 F. Supp. 2d 723, 731 (E.D. Tex. 2002) (applying Texas law); Computer Assocs. Int'l, Inc. v. Altai, Inc., 918 S.W.2d 453, 455 (Tex. 1996); Wise, supra note 342, at 910.

350 Sunpoint Sec., Inc. v. Chesier & Fuller, L.L.P. (In re Sunpoint Sec., Inc.), 377 B.R. 513, 552 (Bankr. E.D. Tex. 2007) (applying Texas law); Murphy v. Campbell, 964 S.W.2d 265, 270 (Tex. 1997).

351 See Berkley v. Am. Cyanamid Co., 799 F.2d 995, 998 (5th Cir. 1986) (applying Texas law); Computer Assocs., 918 S.W.2d at 455; Seureau, 274 S.W.3d at 227-28; Wise, supra note 342, at 910.

352 Computer Assocs., 918 S.W.2d at 456; accord HECI Exploration Co. v. Neel, 982 S.W.2d 881, 886 (Tex. 1998); Wise, supra note 342, at 910. An injury "is inherently undiscoverable if it is by its nature unlikely to be discovered within the applicable limitations period despite the exercise of due diligence." S.V. v. R.V., 933 S.W.2d 1, 7 (Tex. 1996); accord Wagner & Brown, Ltd. v. Horwood, 58 S.W.3d 732, 734 (Tex. 2001); Wise, supra note 342, at 910. To be inherently undiscoverable the injury need not be impossible to discover. S.V., 933 S.W.2d at 7; Wise, supra note 342, at 910. Rather, when determining whether an injury is inherently undiscoverable, a court considers the circumstances surrounding the injury, the degree, of the plaintiff's diligence, and the injury's nature. S.V., 933 S.W.2d at 7; Wise, supra note 342, at 910.

An injury is objectively verifiable if its presence and the wrongful act causing it cannot be disputed, and physical or other evidence exists to corroborate the claim's existence. Achee, 197 F. Supp. 2d at 731; see also S.V., 933 S.W.2d at 4; Wise, supra note 342, at 910.

353 Apex Towing Co. v. Tolin, 41 S.W.3d 118, 122 (Tex. 2001); accord Seureau, 274 S.W.3d at 228; see also HECI Exploration, 982 S.W.2d at 886; Wise, supra note 342, at 910.

354 Via Net v. TIG Ins. Co., 211 S.W.3d 310, 314 (Tex. 2006); Seureau, 274 S.W.3d at 228-29.

355 Seureau, 274 S.W.3d at 229 (citing to Via Net, 211 S.W.3d at 314-15).

356 First-refusal rights in real property transactions are discussed in Part VIII.A.

357 211 S.W.3d at 314.

358 Seureau, 274 S.W.3d at 229 (citations omitted).

359 See discussion supra notes 5 and 48-50.

360 See supra Part III.B.

361 See discussion supra Part II.C (discussing options).

362 A variation on this arrangement is a first-offer right at an appraised price. Under this scheme, an owner willing to sell must have the property appraised and must provide the holder with an opportunity to purchase it at the appraised price. If the holder declines, the owner may sell the property unencumbered for a specified time period at the appraised or a higher price. A further variation requires the owner to propose a price to the holder, which, if not accepted, becomes the seller's floor for negotiation with third parties.

363 The procedure could also be carried out in two steps. In a two-step procedure, the owner would notify the holder of the owner's intention to offer the property for sale and the holder then would be required to trigger the sealed bid auction process. The two-step procedure would bypass the auction process efficiently, if the holder had no interest in, or ability to, acquire the property.

62 BLRLR 433

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